ACCOUNTING GUIDANCE

For

Classified

Public Utility Districts

and

Other Proprietary-Type

Districts

Washington
State Auditor
Brian Sonntag

This guidance is applicable to all classified public utility districts and other proprietary-type districts. Utilities and districts are considered to be classified if their combined annual gross operating revenue exceeds $2 million. These entities are required to prepare their financial statements in conformity with generally accepted accounting principles (GAAP). The reporting package containing required financial reports is provided by SAO as a separate publication. You may obtain copies of both publications by calling the Local Government Support Team at (360) 753-4792 or visiting our web site at www.sao.wa.gov.

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There are three primary authoritative sources of generally accepted accounting principles (GAAP) for local governments:

1. GASB - Governmental Accounting Standards Board
2. FASB - Financial Accounting Standards Board
3. AICPA - American Institute of Certified Public Accountants

The AICPA's Statement on Auditing Standards (SAS) 69, *The Meaning of Presented Fairly in Conformity with Generally Accepted Accounting Principles in the Independent Auditor's Report*, promulgates the new GAAP hierarchy for state and local governments. The new hierarchy replaces the one, which has been in effect since the establishment of the GASB in 1984.

The GAAP hierarchy, as prescribed by the SAS 69, has four categories of sources of accounting principles:

a. GASB Statements and Interpretations, AICPA and FASB pronouncements specifically made applicable to state and local governmental entities by GASB Statements and Interpretations.

b. GASB Technical Bulletins and, if specifically made applicable to state and local governmental entities by the AICPA and cleared by the GASB, AICPA Industry Audit and Accounting Guides and AICPA Statements of Position.

c. AICPA Accounting Standards Executive Committee Practice Bulletins if specifically made applicable to state and local governmental entities and cleared by the GASB, and GASB Emerging Issues Task Force Consensus Positions.

d. Implementation guides ("Qs and As") published by the GASB and practices that are widely recognized and prevalent in state and local government. Also Audit and Accounting Guides/Statement of Position (if specific to government, but not cleared by GASB).

e. Other sources: Concept Statements, pronouncements of the FASB not otherwise applicable, textbooks, articles.

In the absence of established pronouncements, the state and local governmental entities may consider other accounting literature. Other accounting literature includes, for example, GASB Concept Statements; pronouncements establishing accounting principles for nongovernmental entities when not specifically made applicable to state and local governments; Accounting Principal Board (APB) Statements; FASB Concepts Statements; AICPA Issues Papers; International Accounting Standards Committee (IASC) Statements; pronouncements of other professional associations or regulatory agencies; AICPA *Technical Practice Aids*; and accounting textbooks, handbooks, and articles.

GAAP for Proprietary Activities

The GASB Statement 20, *Accounting and Financial Reporting for Proprietary Funds and Other Governmental Entities That Use Proprietary Fund Accounting*, provides additional guidance for establishing a GAAP hierarchy for proprietary activities.

Proprietary fund financial statements should be presented using the economic resources measurement focus and the accrual basis of accounting. Proprietary funds should be reported based on all applicable Governmental Accounting Standards Board (GASB) pronouncements (including all NCGA Statements and Interpretations currently in effect) as well as the following pronouncements issued on or before November 30, 1989[1/], unless those pronouncements conflict or contradict GASB pronouncements: Financial Accounting Standards Boards (FASB) Statements and Interpretations, Accounting Principle Board (APB) Opinions, and Accounting Research Bulletins (ARBs) of the Committee on Accounting Procedure.

[1/] See the GASB Statement 20, *Accounting and Financial Reporting for Proprietary Funds and Other Governmental Entities that use Proprietary Accounting*, for additional details.

In addition, the enterprise funds may also apply all FASB Statements and Interpretations issued after November 30, 1989, except for those that conflict with or contradict GASB pronouncements. Those enterprise funds should apply only those FASB Statements and Interpretations that are developed for business enterprises. They should not apply FASB Statements and Interpretations whose provisions are limited to not-for-profit organizations.

The FASB Statement 71, *Accounting for the Effects of Certain Types of Regulation,* does not specifically exclude state and local governments from its scope, nor does it preclude its application to governmental entities. The Statement and related pronouncements issued on or before November 30, 1989, may be applied to public utility districts that meet the following criteria for reporting as regulated enterprises:

a. The enterprise's rates for regulated services or products provided to its customers are established by or are subject to approval by an independent, third-party regulator or by its own governing board empowered by statute or contract to establish rates that bind customers.

b. If the regulated rates are designed to recover the specific enterprise's costs of providing the regulated services or products.

c. If in view of the demand for the regulated services or products and the level of competition, direct and indirect, it is reasonable to assume that rates set at levels that will recover the enterprise's costs can be charged to and collected from customers.

If a regulated enterprise establishes rates to recover allowable costs, then the accounting prescribed in the FASBS 71 is applicable to that district. It appears that most of the government-owned utilities in the State of Washington meet the criteria of the FASBS 71. The FASBS 71 should be applied to the transactions covered by that Statement.

In the course of the audits, the SAO auditors must have access to sufficient evidence to determine if the accounting treatment covered by the FASBS 71 was correct.

Since the accounting treatment hinges on whether or not the transaction is part of the regulated enterprise's rate structure, our auditors must have access to documentation on how the legislative body addressed the particular issue. It would appear that documenting these decisions in the minutes of the legislative body would be the most efficient means of providing us with the information we need to verify the accounting treatment used.

Ordering Information

The GASB publications are available from:

GASB Order Department
401 Merritt 7
PO Box 5116
Norwalk, CT 06856-5116

The two major FASB publications are: two-volume *Current Text* and five-volume *Original Pronouncements*

The FASB *Current Text* is an integration of current accounting and reporting standards. Material in the *Current Text* is drawn from AICPA Accounting Research Bulletins, Accounting Principles Board (APB) Opinion, FASB Statements of Financial Accounting Standards and FASB Interpretations. It also incorporates the supplemental guidance provided by FASB Technical Bulletins and AICPA Accounting Interpretations. The FASB *Original Pronouncements* contain original texts of: Accounting Research Bulletins, APB Opinions and Statements, AICPA Interpretations, Accounting Terminology Bulletins, FASB Statements, Interpretations, Concepts and Technical Bulletins.

Both publications are updated annually and are available from:

FASB Order Department
PO Box 888-B
Stanford, CT 06904

(Some of the FASB publications are available through the AICPA with membership discounts.)

The AICPA publications are available from:

AICPA Order Department
PO Box 2209
Jersey City, NJ 07303-2209

INTRODUCTION

This section contains the internal control standards to be followed by districts in establishing and maintaining systems of internal control. Internal control systems are to reasonably ensure that the following objectives are achieved:

Expenditures and commitments comply with applicable law.

Assets are safeguarded against waste, loss, unauthorized use, and misappropriation.

Transactions are recorded properly so that reliable financial and statistical reports can be prepared and accountability for assets is maintained.

The following concept of internal control is useful in understanding and applying the internal control standards set forth and discussed on succeeding pages:

> An internal control system consists of the plan of organization and methods and procedures adopted by management to ensure that resource use is consistent with laws, regulations, and policies; that resources are safeguarded against waste, loss, and misuse; and that reliable data are obtained, maintained, and fairly disclosed in reports.

The ultimate responsibility for good internal controls rests with management. Internal controls should not be looked upon as separate, specialized systems. Rather, they should be recognized as an integral part of each system that management uses to regulate and guide its operations. In order to ensure the proper conduct of government business, management must periodically review its internal control systems. This review should be sufficient in scope to provide the answers to several basic questions:

- Are the systems we have in place adequate to manage and account for our resources, meet our goals and objectives, and insure compliance with state and federal regulations?
- Is there an audit trail from our reports to our source documents or will we have to rely on someone to "remember" the facts?
- Are all our departments properly using the systems we have in place and are they complying with our internal policies and procedures?
- Have we strengthened our system of internal control by segregating duties among our employees to provide crosschecks and by providing for the physical security of our assets (e.g., official prenumbered receipts, locking cash drawers, regular inventories, etc.) to the maximum extent practicable?

These are the broad questions your auditor will also seek to answer through the course of his/her audit. If you are satisfied with the results of your review, then there is a much greater likelihood that your auditor will also be satisfied. If you identify problem areas, then you have an opportunity to discuss them with your auditor and to correct them before the auditor is obliged to comment on the problems in his/her report.

The following internal control standards, based on those established by the U.S. General Accounting Office, define the minimum level of quality acceptable for internal control systems in operation and constitute the criteria against which systems will be evaluated. These internal control standards apply to all operations and administrative functions but are not intended to limit or interfere with duly granted authority related to development of legislation, rulemaking, or other discretionary policymaking in an agency.

INTERNAL CONTROL STRUCTURE

Introduction

These internal controls policies are based on the 1994 report issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO) and standards adopted by the American Institute of Certified Public Accountants and the federal Office of Management and Budget.

Internal control is defined in the COSO report as follows:

> Internal control is a process, affected by an entity's board of directors, management and other personnel, designed to provide reasonable assurance regarding the achievement of objectives in the following categories:
>
> - Effectiveness and efficiency of operations
> - Reliability of financial reporting
> - Compliance with applicable laws and regulations

What does this mean for local entities?

Internal control is a management process for keeping an entity on course in achieving its business objectives, as adopted by the governing body. This management control system should ensure that resources are guarded against waste, loss and misuse; that reliable data is obtained, maintained, and fairly disclosed in financial statement and other reports; and resource use is consistent with laws, regulations and policies.

Basic internal control requirements

Each entity is responsible for establishing and maintaining an effective system of internal control throughout their government.

An internal control system should provide *reasonable assurance* that an entity will accomplish its objectives. The concept of reasonable assurance recognizes that the cost of an internal control activity should not exceed the benefit derived from it. Reasonable assurance equates to a satisfactory level of confidence given considerations of costs, benefits, and risks.

The entity's management must identify and analyze the own risks to determine how those risks should be managed. Management defines the level of risk that the entity is willing to accept and strives to maintain risks within those levels.

Each entity should adopt methods to assess risk and review control activities. The methods developed should address each entity's own specific needs.

Components of internal controls

The five components of good internal controls within a management control system are:

1. **Control environment** - The control environment sets the tone of an entity. It influences the control consciousness of its people and it is the foundations for all other components of internal control, providing discipline and structure. Control environment factors include the integrity, ethical values, and competence of the entity's staff; management's philosophy and operating style; the way management assigns authority and responsibility; the way management organizes and develops its staff; and the attention and direction provided by the board.

2. **Risk Assessment -** Every entity faces a variety of risks from external and internal sources, all of which must be assessed. Risk assessment is the identification and analysis of relevant risks to achieving the objectives and forms a basis for determining how risks should be managed. Because economic, regulatory and operating conditions will continue to change, mechanisms are needed to identify and deal with the special risks associated with change.

3. **Control Activities** - Control activities are the internal policies and procedures that help ensure management directives are carried out. They help ensure necessary actions are taken to address risks to achieving the government's objectives. Control activities occur throughout the organization, at all levels and in all functions. They include a range of activities as diverse as approvals, authorizations, verifications, reconciliations, review of operating performance, security of assets and segregation of duties.

4. **Information and Communication** - Pertinent information must be identified, captured, and communicated in a form and time frame that enables people to carry out their responsibilities. Information systems produce reports containing operational, financial, and compliance related information, making it possible to run and control the entity. Effective communication is also essential with external parties, such as taxpayers, vendors, legislators and other interested parties.

5. **Monitoring** - Management systems and internal activities need to be monitored to assess the quality of their performance over time. Assessment is accomplished through ongoing monitoring activities, separate evaluations, or a combination of the two. Ongoing monitoring occurs in the course of operations, including regular management and supervisory activities and other action personnel take in performing their duties. The scope and frequency of separate evaluations will depend primarily on an assessment of risks and the effectiveness of ongoing monitoring procedures. Deficiencies should be reported upstream, with serious matters reported to top management.

Answers to some common questions about internal control

What is a risk assessment?

A risk assessment is an ongoing process to identify, analyze, and manage risk. An entity needs a plan to identify both external and internal risks. The plan will help management understand how those risks affect their activities, assess their significance, manage their effect and provide for continuous monitoring. The following are some examples of external and internal risks:

- External risks arise from activities outside the entity. Technological developments, changing public expectations, legislative directives, natural catastrophes and economic changes all have the potential for creating external risks in an entity.

- Internal risks are less predictable and arise from activities inside the entity. Disruption of the computer systems or telephone systems causes obvious operational problems. When new managers are hired, changes in management style can affect internal control objectives.

How do you identify risks?

Identification of risks can start from existing systems. The budget process, audits, strategic planning, and other chapters included in this manual all provide opportunities for managers to conduct quantitative and qualitative reviews and to identify and prioritize. More informal opportunities include management planning meetings, meetings with auditor, and everyday interaction with staff.

More important than the specific method used to identify risks is management's careful consideration of factors unique to the entity. Some key factors, such as an entity's past experience in failing to meet objectives, staff quality, statutory framework, or the significance and complexity of activities in relation to the entity's mission, should receive management's careful consideration.

By analyzing organizational activities, managers apply risk assessment to functions. Successfully managing risk at the activity level is vital to maintaining an acceptable level of risk for the organization.

What is risk analysis?

Risk analysis involves a careful, rational process of estimating the significance of a risk, assessing the likelihood of its occurrence and considering what actions and controls need to be taken to manage it. Risk analysis also involves estimating the cost to the entity if something does go wrong. That analysis is based on the entity's assumptions about the risk and costs associated with reducing it. Sometimes an actual risk may appear to require one set of actions, but the perceived risk coupled with media reaction to that risk, requires a more expensive set of actions.

It is also important to recognize the distinction between risk assessment (a part of a management control system) and actually managing risk (part of an organization's operations). Limitations on resources will define the level to which risks can be managed.

How do you control or minimize risk?

Control of risk starts with management deciding on the actions necessary to reduce the potential occurrence and significance and the monitoring conditions to remain aware of changing circumstances. Management tools for an early warning system include information systems and ensuring appropriate data is captured, processed, and reported.

If an entity builds its components of a management control system into its planning efforts as well as its daily activities, it is more likely to avoid unnecessary costs; make quick responses as needs arise; and adapt to decreasing resources and changing political and economic climates.

Do control activities increase staffing requirements?

Although control activity procedures are not intended to increase staffing levels, acceptable procedures are to be established and followed which may require changes in existing workloads and/or additional staff position(s). However, a periodic thorough internal review of control activities may identify policies and procedures that are no longer required. It is recognized that some small to medium entities may not be able to institute internal controls on the same level as larger, more complex entities. In those cases where staffing may prohibit or restrict the appropriate segregation of duties, management must either have more active oversight of operations or utilize personnel from other organizational units to the extent possible as compensating controls.

More about control activities

The control activities presented in this section are intended to provide management and other staff with an overview, the use and potential limitations of control activities to manage the risk of achieving the entity's objectives.

Control activities are the policies and procedures that help ensure management directives are carried out. They help ensure that necessary actions are taken to address risks to the achievement of an entity's objectives. Control activities occur throughout the entity at all levels and in all functions.

Control activities are actions taken to minimize risk. The need for a control activity is established in the risk assessment process. When the assessment has identified a significant risk to the achievement of an objective, a corresponding control activity should be determined. If control activities are in place for each significant operation and if management makes sure those activities are carried out properly, staff can be reasonably confident the management control system will provide the necessary assurances.

Control activities and procedures should be considered to ensure the entity is in compliance with the BARS Manual, the Revised Code of Washington, the Code of Federal Regulations, the Washington Administrative Code and other applicable regulatory policies. Generally, those activities and procedures may be categorized into one of the following areas and completed by personnel at various levels:

- **Top-level performance reviews** - Performance reviews should be made of actual performance versus budgets, forecasts, and performance in prior periods. Major initiatives should be tracked and management actions taken to analyze and follow up where appropriate.
- **Direct functional or activity management reviews** - Performance reviews should be made of specific functions or activities. The reviews may focus on compliance, financial, or operational issues.
- **Informational processing -** A variety of control activities should be performed to check the accuracy and completeness of information as well as the authorization of transactions. Development of new systems, and changes to existing ones should be controlled. Additionally, access to programs and data should be restricted.
- **Physical controls** - Equipment, inventories, cash and other assets should be secured physically and periodically counted and compared with amounts shown on control records.
- **Performance indicators -** Certain operating results can be anticipated. By investigating unexpected results or unusual trends, circumstances that jeopardize the achievement of objectives can be identified.
- **Segregation of duties** - Duties are divided, or segregated, among different people to reduce the risk of error or inappropriate actions. For example, responsibilities for authorizing transactions, recording them and handling the related assets should be separated.

What are some potential limitations of control activities?

Control activities, no matter how well designed and executed, can provide only reasonable assurance regarding achievement of objectives. The likelihood of achievement is affected by limitations inherent in all control systems. These limitations include the following:

- **Judgment** - The effectiveness of controls will be limited by the fact that decisions must be made with human judgment in the time available, based on information at hand, and under the pressures to conduct business.
- **Breakdowns** - Even if control activities are well designed, they can break down. Personnel may misunderstand instructions or simply make mistakes. Errors may also stem from new technology and the complexity of computerized information systems.
- **Management override -** Even in effectively controlled organizations, high-level personnel may be able to override prescribed policies or procedures for personal gain or advantage. This should not be confused with management intervention, which represents management actions to depart from prescribed policies or procedures for legitimate purposes.
- **Collusion** - between two or more individuals can result in control failures. Individuals acting collectively often can alter financial data or other management information in a manner that cannot be identified by the control system.
- **Cost vs. benefit** - In determining whether a particular control activity should be established, the risk of failure and the potential effect must be considered along with the cost of establishing the control. Excessive control is costly and counterproductive. Too little control presents undue risk. Entities should make a conscious effort to strike an appropriate balance.

COMMON EVENT CYCLES AND SUGGESTED CONTROL OBJECTIVES
IN FEDERAL AGENCIES

This attachment presents a list of event cycles commonly found in federal agencies and agency components. Also included are certain types of assets that are highly susceptible to loss and for which controls are vital, e.g., cash, materials and supplies. Finally, the list provides suggested control objectives for each event cycle/type of asset.

Event cycles are the processes used to initiate and perform related activities, create the necessary documentation, and gather and report related data. In other words, an event cycle is a series of steps taken to get something done. Each program and administrative function performed within an agency or agency component contains one or more event cycles. For example, an entitlement program could contain the following event cycles: information gathering and verification, eligibility determination, information processing and record keeping, payment, and monitoring. The event cycles for an administrative function could include payroll, procurement of supplies and materials, correspondence handling, etc.

The purpose of the list is to help agencies and agency components identify the event cycles and types of assets and control objectives that need to be considered when performing internal control reviews. The list is neither all-inclusive nor mandatory. Agencies will probably operate event cycles not included on the list and certainly will not operate all cycles included in the list. Also, internal control objectives listed may not be appropriate for a particular situation. Accordingly, each agency should use this list as a guide to identify event cycles and develop internal control objectives for its programs and administrative functions that are covered by these guidelines. (Similar lists are available from the General Accounting Office, professional associations, and private organizations.)

Finally, in establishing control objectives and control techniques, as well as in performing internal control reviews, agencies should be mindful of the inherent limitations (budget constraints, statutory and regulatory restrictions, staffing limitations, etc.), which constrain agency action. Such limiting factors need to be considered in determining whether there is reasonable assurance that the control objectives are being achieved.

I. OPERATIONS CYCLES

The operations cycles are intended to encompass the agency's program activities that are subject to these guidelines. The differences in agency missions make it impossible to develop a representative list of operations cycles and corresponding control objectives. Hence, each agency/agency component should examine its own programs and define the appropriate event cycles and control objectives.

The following are the operations cycles for some typical government programs and the internal control objectives for these cycles.

A. Production Activities

The primary internal control objectives normally associated with production activities include the following:

1. A production plan is authorized defining the products to be manufactured, the timing and quantities of production, and the needed inventory levels.
2. Lead time schedules are timely and accurate and permit realistic due dates.
3. Product quality and engineering standards exist and are monitored to ensure that quality products are produced as efficiently as possible.
4. Production controls exist to ensure that the plant is operating with the optimum mix of resources including labor, equipment, and materials.
5. Production controls exist to prevent the manufacture of unauthorized products or quantities of products.
6. Resources used and products completed are timely and accurately reported.
7. Production costs are computed accurately and recorded timely.
8. Recorded balances of inventory, property, and related activity are periodically substantiated and evaluated.

B. Loans and Loan Guarantees

The primary internal control objectives normally associated with loans and loan guarantees include the following:

1. Applications for loans and loan guarantees are evaluated for appropriateness of eligibility, collateral, if required, and other qualifying criteria prior to approval.
2. Security interest in property used as collateral is properly recorded, filed, and documents secured by a responsible custodian.
3. Accurate receivables agings are prepared systematically and timely.
4. Loan and loan guarantee repayments are collected, controlled and reported in a manner that is consistent with applicable appropriations, other law, and policy.
5. Periodic estimates are made of uncollectible loan balances with such estimates timely reported to management.
6. Proper write-off, conversion, and settlement or forgiveness of delinquent loans is assured.

C. Grants

The primary internal control objectives normally associated with grants include the following:

1. Accurate maintenance of the factors used in distribution formulae for entitlement grants.
2. Grantees' program eligibility requirements are sufficiently detailed to ensure that the program beneficiaries and other interested parties understand the qualifications to receive prescribed benefits.
3. Grantees maintain sound organizational, budgetary and accounting systems that are periodically reviewed and evaluated.
4. Grantees' procurement procedures comply with regulations.
5. Grantees properly maintain, safeguard, and account for government financed property and equipment.
6. Grantees maintain current cost allocation plans and overhead rates.
7. Grantees are paid only for allowable costs and amounts.
8. Financial and compliance audits of grantee activity are performed at least once every two years.
9. Prompt and appropriate grant closeout actions are taken.

II. INTERNAL MANAGEMENT AND ADMINISTRATION CYCLES

A. Organization

The primary internal control objective normally associated with organization includes the following:

1. Responsibility for the performance of all duties is specifically assigned and appropriately separated along with necessary delegations of authority to sufficient numbers of qualified employees.

B. Personnel Policies And Practices

The primary internal control objectives normally associated with personnel policies and practices include the following:

1. Personnel ceilings are strictly enforced.
2. Recruitment, training, evaluation, and termination practices are operating in accordance with applicable laws and regulations and in a manner that promotes economy and efficiency of operations.
3. Appropriate standards of conduct are communicated and enforced.
4. Employment records are promptly, completely and accurately established with proper safeguards against unauthorized access or the preparation of fictitious records.

C. Administrative Support Services

The primary internal control objectives normally associated with administrative services include the following:

1. Services provided meet the organization's legitimate needs.
2. Services are conducted in a manner that promotes economy and efficiency in operations.
3. Safeguards exist to prevent unauthorized or wasteful use of such services.

a. Periodicals, Pamphlets, and Audiovisual Products

- Periodicals, pamphlets, and audiovisual products are related to agency mission, contribute to solution of an identifiable need, and are appropriate in format and scope for the intended audience.

- Periodicals, pamphlets, and audiovisual products are not duplicative of other materials that convey the same message.

- Periodicals, pamphlets, and audiovisual products are produced or acquired in a cost-effective manner.

- Completed periodicals, pamphlets and audiovisual products are consistent with the planned product and distributed in conformance with an approved distribution plan.

b. Consulting and Related Services

- Services are secured for an appropriate purpose, i.e., to obtain specialized opinions or professional or technical advice which does not exist or is not available within the agency or another agency, outside points of view to avoid excessively limited judgments on critical issues, advice regarding developments in industry, university, or foundation research, opinion of noted experts whose national or international prestige can contribute to the success of important projects, or assistance to complete a necessary project within a specified period of time.

- Services are not used to perform work of a policy/decision-making or managerial nature that is the direct responsibility of agency officials, or to bypass or undermine personnel ceilings, pay limitations, or competitive employment procedures; or to aid in influencing or enacting legislation.

- Services are secured through maximum competition, without preference to former government employees.

- Payments for services bear a relation to work completed.

- Services provided meet the organization's specific needs and advice and recommendations are implemented, unless there are valid reasons to the contrary.

c. Long-Term Training

- Long-term training is provided only when the necessary knowledge or set of skills requires a comprehensive study program which cannot be accomplished by a series of unconnected short-term courses; the time span for the acquisition of the knowledge or skill is such that a concentrated or long-term program is most feasible; and the set of knowledge or skills is so complex, new or unique that it cannot be readily obtained on a short-term basis or through other means.

- Nominees continue in agency service for an appropriate period following completion of long-term training.

- Long-term training is relevant to selected employees' current and/or projected assignments, required skills and knowledge, individual development plan, and career potential; and is appropriate for his or her commitment to the organization and Federal service.

d. Space Acquisition and Utilization

- Need for and intended use of space is adequately justified.

- Requesting unit conforms to space allowance standards.

- Request cannot be met by realignment of existing space assignments or use of vacant or under-utilized space.

- Space is leased on the most favorable basis to the Government, with due consideration to maintenance and operational efficiency.

- Lease charges are consistent with prevailing scales in the community for comparable facilities.

- Legal requirements, such as facilities for the handicapped and fire safety features, are satisfied.

- Lease contains provisions necessary to administer the agreement, such as duration of lease, including clearly stated renewal rights; base for future escalations; liquidated damages provision; stated costs for overtime usage; and termination rights.

- Lease conforms to agency and Administration goals and priorities and legal requirements.

D. Advisory and Technical Services

The primary internal control objectives normally associated with advisory and technical services include the following:

1. Services provided meet the organization's legitimate needs.
2. Services are conducted in a manner that promotes economy and efficiency in operations.
3. Safeguards exist to prevent unauthorized or wasteful use of such services.

E. Security and Safeguarding of Classified Material

The primary internal control objectives normally associated with security and safeguarding classified material are the following:

1. Documents are appropriately classified.
2. Appropriate safeguards exist to prevent unauthorized access to classified materials.

F. Audit Follow-up

The primary internal control objectives normally associated with audit follow-up include the following:

1. Audit resolution and corrective actions pertaining to audit recommendations are made on a timely basis.
2. Audits resolved and corrective action on audit recommendations are scheduled in accordance with specific criteria.
3. Accurate records of the status of audit reports and recommendations are maintained through the entire process of resolution and corrective action.

4. Major disagreements between the audit organization and agency management and contracting officials are resolved on a timely basis.
5. Resolution actions are consistent with law, regulation, and Administration policy.
6. Resolution and correction action on recommendations involving more than one program, agency, or level of government are coordinated.
7. Required reports are reliable, accurate, and submitted on a timely basis.
8. Claims arising from audit disallowances are promptly recorded as receivables and collected in accordance with the Federal Claims Collection Act.
9. Interest on audit-related debt is charged promptly, without regard to whether the disallowance is or will be appealed.

III. INFORMATION PROCESSING AND REPORTING CYCLES

A. Information Collection

The primary internal control objectives normally associated with information collection are the following:

1. Information collected is meaningful and useful.
2. Information collected is reliable.
3. Information is arranged in an orderly fashion.
4. Information is maintained on a current basis.

B. Correspondence Handling

The primary internal control objectives normally associated with correspondence handling are the following:

1. Correspondence is channeled to the appropriate parties.
2. Replies are made promptly, accurately and responsively.

C. Records Maintenance

The primary internal control objectives normally associated with records maintenance are the following:

1. Records are readily available.
2. Records are adequately protected.
3. Only necessary records are retained.

D. Automatic Data Processing

The primary internal control objectives normally associated with automatic data processing are as follows:

1. Proper authorization of transaction inputs, adequate edit checks, and necessary safeguards of sensitive input forms to insure accurate, proper, complete and timely entry of information.
2. Data is safeguarded to prevent unauthorized access, improper changes, or loss.
3. Appropriate controls exist to detect unauthorized use of the system.
4. Outputs are produced accurately, completely and timely.

IV. ASSET AND LIABILITY CYCLES

A. Cash

1. Physical security safeguards are maintained where cash is stored and processed.
2. Cash, check signing machines, signature dies, and blank, partially prepared, mutilated, and voided checks are protected from unauthorized use.
3. Receipts are recorded properly and timely and deposited promptly.
4. Disbursements are recorded properly and timely.
5. An effective cash management system is maintained.

B. Negotiable Instruments and Other Investments

The primary internal control objectives normally associated with negotiable instruments and other investments include the following:

1. Physical security safeguards are maintained where negotiable instruments and other investments are stored and processed.
2. Bonds, drafts, and other securities are protected from unauthorized use.
3. Timely and accurate accounting is maintained.
4. Investments comply with legal requirements.
5. Interest and other investment income is collected promptly when due.

C. Letters of Credit

The primary internal control objectives normally associated with letters of credit include the following:

1. Letters of credit are issued only to large dollar recipients who have a continuing relationship with the Federal Government and an adequate cash management system.
2. Amounts available under letters of credit do not exceed available award authority or immediate cash needs.
3. Assurance exists that funds are used only for intended purpose.
4. Cash balances in recipients' hands do not exceed recipients' needs.

D. Receivables

The primary internal control objectives normally associated with receivables include the following:

1. Prompt and accurate recording of all receivables.
2. Ability to determine and report sources and age of receivables.
3. Continuous and timely attempts are made to collect receivables due.
4. Identification of the portion of the receivables that may not be collectible.
5. Validity of write-offs, conversions, and settlement or forgiveness of receivables.
6. Repayments collected, controlled and reported in a manner consistent with applicable law and regulations.
7. Title to property used as collateral is properly recorded, filed, and secured.

E. Capital Assets and Materials Inventories

The primary internal control objectives normally associated with capital assets and materials inventories include the following:

1. Only authorized and needed property is procured.
2. Receipts of property are recorded timely and accurately in source documents and accounting records.
3. Detailed subsidiary records are maintained for individual capital assets and significant categories of materials inventories and are periodically reconciled to control accounts.
4. Periodic physical verification is made of the existence and condition of property and inventories.
5. Physical security measures are commensurate with the size, type and value of property.
6. Issues, transfers, retirements, and losses are reported and accounted for timely.
7. Assets are properly requisitioned and used exclusively for government activities.
8. Records of asset use are accurately maintained.

F. Payables, Debt, and Other Liabilities

The primary internal control objectives normally associated with payables, debt, and other liabilities include the following:

1. All payables and other claims against the government are recorded promptly and accurately.

2. Prepayment examinations and certifications of performance are made to ensure validity and clerical accuracy of claims prior to payment.
3. Debt and other long-term liabilities are properly authorized, recorded and serviced in accordance with applicable laws and regulations.

G. Fiduciary Funds

The primary internal control objectives normally associated with fiduciary funds include the following:

1. Liabilities to others are recorded properly.
2. Detailed subsidiary records are maintained and are periodically reconciled to control accounts.
3. Funds are handled in accordance with applicable law and regulations.
4. Effective control is maintained by responsible officials.
5. Benefits and other disbursements are subject to comparable controls to other payments.

V. RECEIPTS CYCLES

A. Taxes and Duties

The primary internal control objectives normally associated with taxes and duties include the following:

1. Taxing programs are applied to all individuals and organizations subject to taxes.
2. Tax returns and assessments are reasonably correct.
3. All receipts are recorded accurately and timely.
4. Receipts are safeguarded while in the custody of the agency and promptly transferred to the Treasury.
5. Settlements, allowances, and refunds are properly authorized.
6. Taxing programs are administered in accordance with applicable laws and regulations.

B. Services Rendered

The primary internal control objectives normally associated with services rendered include the following:

1. Revenues are recorded immediately as services are rendered with accounts receivable promptly set up and billed on a timely basis if not paid in full.
2. Receipts are recorded accurately and timely.
3. Receipts are safeguarded while in the custody of the agency and promptly transferred to the Treasury.
4. Services rendered and related charges are conducted in accordance with applicable laws and regulations.

C. Other Sales

The primary internal control objectives normally associated with other sales include the following:

1. Sales are recorded immediately as items are sold with accounts receivable promptly set up and billed on a timely basis for non-cash sales.
2. Receipts are recorded accurately and timely.
3. Receipts are safeguarded while in the custody of the agency and promptly transferred to the Treasury.
4. Sales of goods, property, equipment, bonds, notes, and other items are conducted in accordance with applicable laws and regulations.

D. Fines, Penalties, and Judgments

The primary internal control objectives normally associated with fines, penalties, and judgments include the following:

1. Fines, penalties, and judgments are levied on or sought from individuals and organizations as required by laws or regulations.
2. Fines and penalties are charged at the proper statutory rate.
3. All receipts are recorded accurately and timely.
4. Receipts are safeguarded while in the custody of the agency and are promptly transferred to the Treasury.
5. Rescissions and forgive nesses are properly authorized.

E. Other Receivable Collections

The primary internal control objectives normally associated with other receivable collections include the following:

1. All receipts are recorded accurately and timely.
2. Receipts are safeguarded while in the custody of the agency and are promptly transferred to the Treasury.
3. Procedures for effecting collection, including offset and installment payments, are utilized on a timely basis.

F. Other Receipts

The primary internal control objectives normally associated with other receipts include the following:

1. All receipts are recorded accurately and timely.
2. Receipts are safeguarded while in the custody of the agency and are promptly transferred to the Treasury.
3. Moneys are requested and received in situations where warranted in accordance with applicable laws and regulations.

VI. DISBURSEMENT CYCLES

A. Payroll, Pensions and Other Fringe Benefits

The primary internal control objectives normally associated with payroll, pensions and other fringe benefits include the following:

1. Appropriate authority exists for the appointment, change, and termination of all personnel.
2. Compensation and benefit payments are in accordance with current statutory or regulatory limitations.
3. Payments are made only in return for services rendered.
4. Gross and net payroll amounts and payroll deductions are correct.
5. Payroll charges, including fringe benefits, are recorded and distributed promptly.
6. Timely, accurate and complete subsidiary records are maintained of vacation, sick leave and other balances.

B. Federal Assistance Payments to Other Governmental Units and Individuals

The primary internal control objectives normally associated with federal assistance payments to other governmental units and individuals include the following:

1. Disbursements are valid and properly approved.
2. Disbursements are recorded promptly and accurately to the appropriate accounts.
3. Payments are within budget limits and in accordance with applicable laws, regulations and agreements.
4. Payments are made only to eligible recipients for eligible costs.
5. Payments are made promptly and in full.

C. Procurement and Acquisition

The primary internal control objectives normally associated with procurement and acquisition include the following:

1. All purchases are authorized within budget limits and made in accordance with applicable laws, regulations and agreements.
2. Government has paid lowest prices commensurate with quality, service, delivery and reliability.
3. Purchases and acquisitions are received and examined for acceptability.
4. Disbursements are valid and properly approved.
5. Disbursements are made on a timely basis.
6. Disbursements are recorded promptly and accurately to the appropriate account.

D. Travel Advances and Reimbursements

The primary internal control objectives normally associated with travel advances and reimbursements include the following:

1. Travel reimbursements and advances are provided only for properly authorized travel.
2. Amounts paid are in accordance with applicable government travel regulations.
3. Reimbursements are timely, properly approved, and properly recorded to the appropriate accounts.
4. Advances are liquidated within reasonable time periods.

E. Other Expenditures

The primary internal control objectives normally associated with other expenditures include the following:

1. Expenditures are valid and properly approved.
2. Expenditures are recorded promptly and accurately in the appropriate accounts.
3. Debt service requirements, refunds, valid claims and other appropriate payments are made timely in full accordance with applicable laws, regulations, and agreements.

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Chapter 2. Revenues and Receipts — Page

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The electronic funds transfer (EFT) is the deposit to or disbursement from a bank account by means of wire or other electronic communication. RCW 39.58.750 governs the circumstances under which electronic fund transfers may be used. We prescribe the following accounting procedures:

1. Receiving money by the EFT:

   a. Prepare a treasurer's receipt upon receiving notice from the payer that the funds have been transferred to your bank account. Do not wait for the bank to notify you of receipt of the funds. However, you may want to contact your bank to confirm the expected funds have arrived.

      Enter the following information on the receipt:

      $ Date of receipt.
      $ Name of person, company or agency transferring money into your account.
      $ Name and number of fund(s).
      $ BARS or other accounting system revenue account number.
      $ Notation that funds were received by the EFT.

   b. A file must be maintained of those payers who have agreed in writing to add money to your account electronically.

2. Disbursing money by the EFT:

   a. Prepare a record, which shows:

      $ Chronological number of the EFT payment.
      $ Time and date of disbursement.
      $ Payee - name, address and account number.
      $ Amount of disbursement.
      $ Purpose of disbursement.
      $ Expense account number.
      $ Name and number of fund(s).
      $ Disbursing bank's unique transaction identification number, if available.
      $ Receiving bank or financial institution's identification number.

   b. A file must be maintained of authorizations signed by payees who have thereby agreed to have money added to their accounts electronically.

   c. The treasurer should notify the disbursing bank that access to files, records and documentation of all EFT transactions involving the treasurer should be provided to the State Auditor when required for the conduct of the statutory post audit.

Cash receipting is a very important function of all governments. Listed below are requirements for deposits and receipt forms. Also provided are recommended internal control procedures for cash receipts. Internal controls are responsibility of the management.

1. Deposits.

   a. Every public officer and employee, whose duty it is to collect and receive payments due or for the use of the public, should deposit such monies collected or received by him/her with the treasurer of the local government once every twenty-four hours. The treasurer of the local government may at his/her discretion grant an exception where such daily transfers would not be administratively practical or feasible (RCW 43.09.240).

   b. Deposits must be made intact and the composition of checks and cash must match the mode of payment listed on the deposit slip and related receipt forms.

   c. Checks must be restrictively endorsed *For Deposit Only* immediately upon receipt.

2. Receipt Forms (manual or automated).

   a. Receipt forms must be pre-numbered and imprinted with the name of the district.

   b. Receipt forms must include the following information:

      - Name of payor (address if feasible).
      - Amount received.
      - Mode of payment (cash, check, credit card, other).
      - Purpose of payment.
      - Name of employee who prepares receipt.

   c. Generic receipt forms should not be used (e.g., Rediform, etc.).

   d. In instances where cash is received at decentralized locations (e.g., police department, parks department, etc.), the district's treasurer may combine those receipts onto one treasurer's receipt. The treasurer's receipt should indicate the total amount received from each location as well as the appropriate account codes.

   e. If a receipt is voided, the original and any copies of that receipt must be retained.

3. Internal Controls.

   The following internal controls enable districts to properly account for and safeguard cash receipts.

   a. Two employees should open the daily mail and prepare a list of cash and checks received (remittance list). This may not be feasible at departments/districts having limited staff. In such a case, the entity should implement a system of supervisory review of the remittance list and bank deposits.

   b. The daily deposit should be prepared by someone other than the person who received the payment. As noted above, this control may not be feasible at departments/districts having limited staff. In such a case, the entity should implement a system of supervisory review of the remittance list and bank deposits.

   c. Checks received in the mail should be briefly reviewed for accuracy (e.g., proper payee, date, signature of payor, etc.). Checks with obvious inaccuracies should not be included in the deposit. In such a case, the entity should contact the payor and request that the payment be corrected or reissued.

d. The daily remittance list should be compared (reconciled) to daily deposit slips and to the cash receipts journal (or check register) on a regular basis. This should be performed by someone other than the employee who prepared the remittance list. Any shortage should be resolved.

e. A duplicate copy of the bank-validated deposit slip showing the composition of receipts should be retained by someone other than the employee making up the deposit.

f. A monthly bank statement reconciliation should be performed by an independent person who does not have cash custody or bookkeeping responsibilities over cash. Any differences that are identified during the monthly bank reconciliation should be researched and resolved.

g. The daily deposit should be delivered to the bank in the bank bags and should have locks or other tamper-proof devices.

h. Cash receipts should be properly protected during the operating day and secured in a safe or vault overnight. Access to the cashiering area should be appropriately restricted whenever possible.

i. Access to the safe or vault should be limited and combination should be changed periodically. In addition, the safe and vault combination should be changed after employees terminate employment.

j. If the district utilizes cash registers, there should be only one change fund and one cash register (or drawer) per cashier. This enables the district to affix responsibility for cash to a specific individual at all times.

k. Accounting manuals or policies should contain instructions for identifying cash receipts and for dating cash receipts journal entries for that day's receipts.

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Deferred Compensation Plans (Internal Revenue Code, Section 457)

RCW 41.50.770 authorizes all political subdivisions to defer income for all officials and employees. This statute also allows political subdivisions to enter into agreements with certain institutions, such as banks, savings and loan associations and insurance companies, to establish deferred compensation plans for the benefit of their employees. These plans must be in conformity with the requirements of Section 457 of the Internal Revenue Code.

Deferred compensation plans permit employees to accept less than the full amount of salary earned thus reducing their current federal income tax liability. The amount by which the salary is reduced is invested by the employer and upon retirement, disability, termination, unforeseen emergency, or death may be withdrawn by the employees or their beneficiaries.

The plan must be established correctly and administered properly so that the Internal Revenue Service (IRS) does not rule that the plan is not in conformity with the requirements of Section 457 of the Internal Revenue Code.

Because of the many plans available, it is strongly recommended that any district which intends to establish a deferred compensation plan seek legal counsel to determine conformance with the Internal Revenue Code, Section 457, effective August 20, 1996[1], and obtain approval of the chosen plan by the district.

Caution should be exercised in implementing a plan, not only to protect the employer's legal liability, but also to prevent undue administrative complexities. No one can identify all problem areas of deferred compensation plans and their administration, as many problems may surface as a result of choosing a particular carrier, product or administrative system. Some major administrative requirements are as follows:

a. Make Written Agreements with Plan Administrator

All deferred compensation plans should provide for written agreements, which clearly define the duties and responsibilities of the employer and the administrator.

b. Keep an Employee File for Each Employee

A file to keep a deferred compensation record for each participating employee is necessary. Most carriers will provide the forms and basic accounting information for the employer, but the employer is responsible for maintenance of the files.

The participating employees must complete and sign joiner agreements stipulating the amount of their gross salaries or wages to be deferred. The district should also maintain a written agreement, which details any responsibilities of the employer for contributions, fees, charges, earnings, losses and withdrawals.

c. Withdrawals

The procedures for withdrawals should be clearly defined and the employer should be very careful in accepting any employee requests for amounts to be withdrawn from accumulated deferred compensation assets for unforeseeable emergencies, as any employee withdrawal granted which does not qualify under Internal Revenue Code Section 457 could cause the entire deferred compensation plan for all employees to be considered in violation and invalid by the IRS.

Normally, all withdrawals as a result of retirement, disability, termination, unforeseen emergency or death, will be paid to the employer by the bank, credit union, or other institution (the agent) with which the employer (the principal) has the agreement.

[1] The deferred compensation plan was revised by the H.R. 10 which was included in the Economic Growth and Tax Relief Reconciliation Act of 2001 and signed into law on June 7, 2001.

In such cases, the employer will receipt for the payment referred to above, deduct the appropriate amount for federal income tax withholding and disburse the remaining amount to the employee, former employee or beneficiary as applicable. The employer will then remit the federal income tax withheld to the IRS or to the official depository as it presently is required to do. The employer will issue W-2 forms to the participants in the plan who have received payments of deferred income.

The W-2 will show the gross payment made to the participant or beneficiary and any deductions made.

However, the IRS has approved some plans whereby the administering company acts as agent for payments to the employees, issuance of W-2 forms and remittances to the IRS. Such IRS approved plans, which are still in conformance with the requirements of Section 457 Internal Revenue Code, will be permitted.

d. Maximum Contribution

Beginning January 2002, employees may defer the less of either 50 percent of their gross annual compensation (reduced by other tax-deferred retirement contributions and pre-tax salary reductions) or $11,000 annually. The new contribution limit will increase by $1,000 a year until it reaches $15,000 in 2006. After 2006, the annual contribution limit will be indexed to inflation in $500 increments.

Employees age 50 or older can invest an additional $1,000. This additional contribution amount will increase by $1,000 every year until it reaches $5,000 in 2006. After 2006, the annual contribution limit will be indexed to inflation in $500 increments.

During the last three years prior to retirement, the employee may use the catch-up limitation which starting January 2002 is $22,0000 annually and will be increased by $2,000 a year until it reaches $30,000 in 2006.

e. Establish Plan as a Pension (and Other Employee Benefit) Trust Fund (if Applicable)

All IRC Section 457 plans have to be held in a trust for the exclusive benefit of participants and their beneficiaries.

Under the new law, the local governments do not own either the amounts deferred by employee or related income on those amounts. Accordingly, the GASB Statement 32[1/], Accounting and Financial Reporting for Internal Revenue Code Section 457 Deferred Compensation Plans, requires the local governments to report their plans as pension (and other employee benefit) trust funds in their financial reports. This requirement applies only to the governments, which administer the deferred compensation plan by themselves.

The districts should keep detailed accounting records of the deferred compensation plan. However, if those records can be provided by the administrator of the plan, no duplication is necessary.

[1/] As amended by the GASB Statement 34, *Basic Financial Statements - and Management Discussion and Analysis - for State and Local Governments*.

Travel expense includes amounts paid for use of personal automobiles, other transportation, and actual expenses or reimbursement in lieu of actual expenses for meals, lodging, and related items.

The legislative body of each municipality must pass an ordinance or resolution to establish rules and regulations for the reimbursement of travel expense. There should be rules to cover all officials and employees. The ordinance or resolution should discuss the municipal policy on tipping, charging expenses to the district, and it should prohibit reimbursement for personal expenses and entertainment.

If any district wishes to issue credit cards for travel related expenses, the legislative body must pass a resolution to establish rules and regulations that satisfy provisions of Chapter 42.24 RCW, including:

1. Submission of a fully itemized travel expense voucher by the employee or officer;
2. Settlement by the officer or employee within 30 days of the billing date; and,
3. The establishment of a lien against salary for any disallowed charges.

Claims for reimbursement of travel expenses must contain a signed certification that includes the following language, AI hereby certify under penalty of perjury that this is a true and correct claim for necessary expenses incurred by me and that no payment has been received by me on account thereof.@

In addition, if an officer or employee is filing a claim on behalf of others, he/she must prepare a detailed account that includes:

1. Names of the others who traveled, partook of meals, or otherwise incurred expenses.
2. Whether they were district employees and, if not, who they were and what connection they had with district business. This should not be construed to permit promotional hosting.
3. Who provided the lodging, meals or other services in question, dates and times.
4. A detailed breakdown of amounts.
5. Some statement sufficiently explicit to show what district business was being carried out when the expenses were incurred.

If a district chooses the option of using monthly reimbursements for use of personal automobiles for official business, the following procedures apply.

1. The monthly rate schedule established should be limited to officers and/or employees who actually use their personal automobiles for travel on a regular basis. It is the responsibility of the district to assure that each traveler is on official business.
2. The rate must be based on actual costs.
3. A periodic review must be performed to determine whether or not the rate continues to reflect actual costs.
4. A record is needed of the legislative body’s determination.

If the above procedures are not followed, the “monthly reimbursement for use of personal automobiles” may be treated as additional compensation. According to the Internal Revenue Service, districts could be assessed the withholding tax of the employees if the amounts advanced/reimbursed for travel were not for expenses incurred or reasonably expected to be incurred, unless these amounts are reported as taxable wages on the W-2.

If a district chooses to establish an *advance travel expense account* (imprest account), pursuant to RCW 42.24.120, the following procedures apply:

1. The imprest amount must be established and maintained in accordance with the procedures prescribed for petty cash (e.g., amount must be established by a resolution).

2. Upon receipt of the money, the custodian should open a checking account in a local bank in the name of the district entitled “Advance Travel Expense Account - John Doe, Custodian.” Money received from the following sources will be deposited to the account:

From the treasurer or other disbursing officer, the total amount originally establishing the account or subsequently added; from officers and employees, refunds of any unexpended advances; and from the warrant-issuing officer, amounts that reimburse the custodian for travel expenses allowed in the settlement of employee advances.

3. The *advance travel expense account* must be used solely for travel advances, <u>not direct payments to vendors</u>. In other words, money may be advanced to an individual who is going on travel status for travel-related expenses that he/she will pay out of his/her own pocket. It must not be used for personal loans, registration fees, reimbursements to employees or officers for travel already incurred, etc.

4. The district should maintain a check register and use it to record all transactions of the account, including deposits, disbursements and bank service charges. Reconciliation should be done with the bank statement at the end of each month. When possible, the reconciliation should be done by someone other than the custodian. The balance remaining in the checking account as of a given date, together with any outstanding advances and travel expense claims on hand but not yet reimbursed, should always equal the amount established by the legislative body for the account.

5. Employee advances for travel expenses should be made by the issuance of checks drawn on the special bank account, payable to the applicant. Approved requests will be retained in the files of the custodian to support such advances until final settlement is made and claim for reimbursement has been submitted. Requests for such advances should be reasonable estimates of the applicants' travel expense requirements and should contain as a minimum the following information:

   Date of request
   Name of applicant
   Destination
   Purpose of travel
   Anticipated departure and return dates
   Amount requested
   Signature of applicant
   Official approval of trip
   Check number, amount and date (to be provided by the custodian when the advance is made)

6. Settlement of advances should be made on or before the 15th day following the close of the travel period by filing with the custodian an expense voucher as required by RCW 42.24.090. The custodian should verify the amount shown on such form as having been advanced to the employee. In the event the traveler's actual expense is less than the amount of the advance received, the unexpended portion of the advance should accompany his/her expense voucher. The expense voucher and original request for the advance should then be used to support the custodian's claim for a warrant replenishing the account for travel expenses reported. Expense vouchers containing expenses in excess of the amount advanced should be submitted in duplicate to the custodian at the time of final settlement. The original copy of the expense claim and the traveler's request for an advance should then be used to support the custodian's claim for a warrant replenishing the account. The other copy of the expense claim should be submitted to the warrant issuing officer for reimbursement of the excess to the traveler. Claims for reimbursement to the account should be submitted by the custodian periodically as needed and at the end of the fiscal year in order that all expenses incurred will be charged against the appropriations for the period then ending.

7. Any default in accounting for or repaying an advance should render the full amount which is unpaid immediately due and payable with interest at the rate of 10 percent per annum from the date of default until repaid. To protect against any losses on advances, the legislative body should have a prior lien against and a right to withhold any and all funds payable or to become payable to such officer or employee to whom such advance has been given, up to the amount of the advance and an annual interest rate of 10 percent until repayment or justification is made (RCW 42.24.140). No advance of any kind may be made to any officer or employee at any time when he/she is delinquent in accounting for or repaying a prior advance.

Petty cash includes change funds, working funds, revolving, advance travel, stamp funds, check cashing funds, etc.; in other words, any sum of money or other resources set aside for such specific purposes as minor disbursements, making change, and similar uses (i.e., imprest fund). If the petty cash is disbursed, it is periodically restored to its original amount by a warrant drawn and charged to the applicable operating fund. The amount of the warrant should equal the aggregate of the disbursements.

The following are minimum requirements for the establishment and operation of petty cash accounts.

1. The legislative body must authorize each petty cash account in the manner that local legislation is officially enacted, i.e., resolution, etc. This applies also to all subsequent increases or decreases in the imprest amount.

2. The legislative body or its delegate must appoint one custodian of each petty cash account who should be independent of invoice processing, check signing, general accounting and cash receipts functions. As part of the appointment, the custodian should render a receipt for the imprest amount to the treasurer, clerk-treasurer or auditor from whom he/she receives it.

   When it is not practical to hire additional personnel or to reallocate these duties among existing personnel, the legislative body must establish some mechanism of review that accomplishes the objectives of the segregation of duties. For example, periodic monitoring of cash receipts and/or independent performance of the bank reconciliation add controls when complete segregation of duties is not possible.

3. The legislative body or its delegate should assure that the amount in petty cash is periodically counted and reconciled by someone other than the custodian.

4. The custodian should assure the petty cash is kept in a safe place.

5. The imprest amount may be established by treasurer’s check or in double entry systems by warrant.

6. The legislative body must include the authorized amount of all such petty cash in the district’s balance sheet.

7. If petty cash is disbursed, it must be replenished at least monthly by warrant or check payable to the custodian. No other receipts may be deposited to the petty cash fund.

   The replenishment should be subject to the same review and approval as processed invoices. The replenishment must be by voucher with the appropriate receipts attached. The receipts should show the date, recipient, purpose, and amount of each cash disbursement. These receipts must be signed by the person receiving the money, stamps, etc. The receipts should be perforated or canceled by some other appropriate means to prevent reuse. At the time of replenishment, the custodian should ensure that the balance remaining in petty cash, together with the amount of the replenishment voucher, equals the authorized imprest amount.

8. The imprest amount of petty cash should not exceed one month’s salary or the surety bond covering the custodian.

9. The fund may not be used for personal cash advances even if secured by check or other I.O.U.s. To avoid appearance of personal loan, deposits of cashed checks, warrants, and drafts should be made daily. Districts should avoid cashing checks out of (from) cash receipts because this destroys the intactness of deposits. See the separate procedures applicable to advances for travel expenses.

10. Petty cash should always be replenished at the end of the fiscal year so that expenses will be reflected in the proper accounting period.

11. Whenever an individual’s appointment as custodian is terminated, the fund must be replenished and the imprest amount turned over to the treasurer or other disbursing officer.

All claims against a district must be preaudited by the auditing officer of the district or his/her delegate. In addition, all claims must be certified by the auditing officer. This certification may be made on each individual claim voucher or, subject to the acceptance and approval of the district's legislative body, a blanket voucher certification may be used so long as it indicates the particular vouchers so certified. The use of a blanket certification in no way relieves the auditing officer of his/her responsibility and liability for each individual voucher so certified. The certification must be signed and dated by the auditing officer or his/her delegate. For all claims, except expense reimbursement claims certified by officers or employees (see Chapter 3, Section B, *Employee Travel*), the certification must include the following language:

> *I, the undersigned, do hereby certify under penalty of perjury that the materials have been furnished, the services rendered or the labor performed as described herein and that the claim is a just, due and unpaid obligation against the __(district)__ and that I am authorized to authenticate and certify to said claim.*

The auditing officer's certification for employee/officer expense reimbursement claims must include the following language:

> *I, the undersigned, do hereby certify under penalty of perjury that the claim is a just, due and unpaid obligation against the __(district)__ and that I am authorized to certify to said claim.*

The certification by the auditing officer in no manner relieves members of the legislative body from the responsibility and liability for each voucher approved. It is the legislative body's responsibility to ensure that the system of auditing and certifying vouchers is operating in a manner to provide the greatest possible protection for the legislative body members and the district.

To indicate the legislative body approval for payment of claim vouchers and payroll, the following should be entered in the minutes:

The following voucher/warrants are approved for payment:

(Funds)				**Total**
Voucher (warrant) numbers:	________________	**through**	________________	**$**________________
Payroll warrant numbers:	________________	**through**	________________	**$**________________

If the legislative body authorizes the procedure, districts may issue warrants before the legislative body approves claims. To do this the district must enact the following policies and procedures (required in Chapter 42.24 RCW):

(1) The auditing officer and the officer designated to sign the checks or warrants must have an official bond. The amount should be determined by the legislative body but cannot be less than fifty thousand dollars (RCW 42.24.180);

(2) The legislative body should adopt contracting, hiring, purchasing, and disbursing policies that implement effective internal control;

(3) The legislative body must review and approve the claims paid at its next regularly scheduled public meeting; and

(4) If the legislative body disapproves some claims, the auditing officer and the officer designated to sign the checks or warrants must recognize these claims as receivables of the district and pursue collection diligently until the amounts are either collected or the legislative body is satisfied and approves the claims.

The legislative body may stipulate that certain kinds or amounts of claims should not be paid before the board has reviewed the supporting documentation and approved the issue of checks or warrants in payment of those claims.

The original copy of all vouchers should be filed in the office of the auditing officer of the district. The detailed accounts to which the expenses are to be posted must be clearly designated. Supporting documentation must be retained and either attached to the vouchers or canceled by the auditing officer to prevent reuse.

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The requirements described below apply to all local governments who expend federal funds or pass funds through to subrecipients. Federal assistance can be provided to state and local governments in many forms including *project grants, block grants, formula grants, cost reimbursement contracts, loans, loan guarantees, insurance contracts, real property, and personal property*. The following procedures apply to programs funded with state and interlocal money as well as federal funds. This section does not apply to entitlements or shared revenues, which are treated essentially as local revenues.

Excerpts from Office of Management and Budget (OMB) Circular A-133, Circular A-87, and the Common Rule are provided in this section. Please note that there are many additional federal laws and regulations that may apply to your grants and loans. Copies of these circulars and other federal documents can be obtained from the OMB website: www.whitehouse.gov/omb.

The Common Rule

The Common Rule (an attachment to the OMB Circular A-102) sets forth uniform administrative requirements for grants and cooperative agreements to state and local governments. The financial management systems of local governments and subgrantees must meet the following standards:

1. Financial reporting. Accurate, current, and complete disclosure of the financial results of financially assisted activities must be made in accordance with the financial reporting requirements of the grant or subgrant.

2. Accounting records. Grantees and subgrantees must maintain records, which adequately identify the source and application of funds provided for financially assisted activities. These records must contain information pertaining to grant or subgrant awards and authorizations, obligations, unobligated balances, assets, liabilities, outlays or expenditures, and income.

3. Internal control. Effective control and accountability must be maintained for all grant and subgrant cash, real and personal property, and other assets. Grantees and subgrantees must adequately safeguard all such property and must assure that it is used solely for authorized purposes.

4. Budget control. Actual expenditures or outlays must be compared with budgeted amounts for each grant or subgrant. Financial information must be related to performance or productivity data, including the development of unit cost information whenever appropriate or specifically required in the grant or subgrant agreement. If unit cost data are required, estimates based on available documentation will be accepted whenever possible.

5. Allowable cost. Applicable OMB cost principles, agency program regulations, and the terms of grant and subgrant agreements will be followed in determining the reasonableness, allowability, and allocability of costs.

6. Source documentation. Accounting records must be supported by such source documentation as canceled checks, paid bills, payrolls, time and attendance records, contract and subgrant award documents, etc.

7. Cash management. Procedures for minimizing the time elapsing between the transfer of funds from the U.S. Treasury and disbursement by grantees and subgrantees must be followed whenever advance payment procedures are used. Grantees must establish reasonable procedures to ensure the receipt of reports on subgrantees' cash balances and cash disbursements in sufficient time to enable them to prepare complete and accurate cash transactions reports to the awarding agency. When advances are made by letter-of-credit or electronic transfer of funds methods, the grantee must make draw downs as close as possible to the time of making disbursements. Grantees must monitor cash draw downs by their subgrantees to assure that they conform substantially to the same standards of timing and amount as apply to advances to the grantees.

OMB Circular A-87

Expenditures of federal funds and costs claimed for reimbursement or used for matching must be determined in accordance with the OMB Circular A-87, *Cost Principles for State and Local Governments*. This circular provides criteria for determining whether costs are necessary, reasonable, and allocable. It also lists specific types of costs and expenses that are allowable and unallowable.

OMB Circular A-133

The Single Audit Act of 1984 set forth uniform requirements for audits of federal financial assistance provided to state and local governments. Amendments to the Single Audit Act were signed into law in July 1996. These amendments are effective for audits of fiscal years beginning after June 30, 1996. Prior to the 1996 amendments, single audit regulations were set forth in OMB Circular A-128, *Audits of State and Local Governments*. The OMB has since rescinded this Circular. As a result, single audit requirements are now provided in the OMB Circular A-133, *Audits of States, Local Governments, and Non-profit Organizations*.

According to the OMB Circular A-133, " . . . non-federal entities that expend $300,000 or more in a year in federal awards shall have a single audit conducted . . . except when they elect to have a program-specific audit . . .." The election of a program-specific audit is allowable only if the auditee expends federal awards under only one program (excluding Research and Development) and the federal program's laws, regulations, or grant agreements do not require a financial statement audit.

Circular A-133 outlines specific responsibilities for the auditee. In short, the auditee must perform the following:

1. Identify, in the accounting records, all federal awards received and expended, including the name of the federal grantor agency and pass-through agency (if applicable), the CFDA title and number, and the award number and year;

2. Maintain internal control over federal programs that provides reasonable assurance that the grantee is managing federal awards in compliance with laws, regulations, and the provisions of contracts or grant agreements that have a material effect on each of its federal programs;

3. Comply with laws and regulations and the provisions of contracts or grant agreements related to each of its federal programs;

4. Prepare appropriate financial statements and Schedule of Expenditures of Federal Awards;

5. Ensure audits are performed and submitted when due;

6. Follow up and take corrective action on audit findings, including preparation of a Summary Schedule of Prior Audit Findings and a Corrective Action Plan; and

7. Submit a Data Collection Form and a reporting package to the federal clearinghouse (refer to the Circular A-133 for details).

Governments that expend less than $300,000 in a year in federal awards are exempt from federal audit requirements for that year, but records must be available for review or audit by appropriate officials of the federal agency, pass-through entity, and General Accounting Office (GAO).

ADDITIONAL AUDITS BEYOND SINGLE AUDITS

The Single Audit Act provides that an audit made in accordance with the Circular A-133 should be in lieu of any financial or financial compliance audit required under individual federal assistance programs. To the extent that a single audit provides federal agencies with information and assurances they need to carry out their overall responsibilities, they should rely upon and use such information. However, a federal agency should make additional audits, which are necessary to carry out its responsibilities under federal law and regulation. Any additional federal audit effort should be planned and carried out in such a way as to avoid duplication.

To satisfy the requirements of the Single Audit Act and the requirements of generally accepted accounting principles contained in the NCGA Statement 2, the following accounting for grants is prescribed.

1. Project Coding

   At the inception of a grant (award notification), one or more project codes should be assigned locally to identify the particular grants. The coding does not have to be incorporated into the district's accounting system, as long as it allows the district to track how much grant funds district is approved for and how much is left at the end of the award year.

   The use of multiple codes may be necessary when there is more than one source of funds for a particular project. In addition, it may be desirable or necessary to account for the local share of costs ("match") or program income in separate projects. The value of separate projects is that they immediately segregate revenues, expenses, cash accounts, receivables, and payables for each grant and for the related non-grant resources used to accomplish the project or operate the program.

2. Local Funding of Grant Projects

   Within this project or set of projects, the district should account not only for grant resources and expenses but also for the district's own contributions to the project or program and for related program income. This is necessary to ensure uniform accounting for the entire project or program, not merely that portion supported by grant money.

3. Grant Schedules

   A set of grant schedules is prepared as shown in the reporting package. These schedules meet federal requirements for the Single Audit.

4. Noncash Awards

   The value of noncash awards (e.g., food stamps, food commodities, etc.) should be accounted for and reported on the Schedule of Expenditures of Federal Awards and the Schedule of State and Local Financial Assistance. Current year expenses should be the value of goods distributed during the year. The notes to the schedule should disclose the nature of the amounts reported.

The Governmental Accounting Standards Board (GASB) Statement 24, *Accounting and Financial Reporting for Certain Grants and Other Financial Assistance*, defines pass-through grants as those grants and other financial assistance received by a governmental entity (recipient government) to transfer to or spend on behalf of a secondary recipient. All pass-through grants received by a governmental entity should be reported in its financial statements. To determine the proper accounting for pass-through grants, the recipient government has to evaluate its administrative and direct financial involvement.

Administrative involvement may include:

(a) monitoring secondary recipients for compliance with program-specific requirements,
(b) determining eligible secondary recipients or projects, even if using grantor-established criteria, or
(c) having the ability to exercise discretion in how the funds are allocated.

Direct financial involvement may include:

(a) recipient government financing some direct program costs because of a grantor-imposed matching requirement, or
(b) recipient government liability for disallowed costs.

If a recipient government has administrative involvement or direct financial involvement in a pass-through grant, its responsibility in relation to the resources is more than custodial.
The recipient government essentially exercises operational responsibility or discretion over whether the grant will be awarded.

The National Council on Governmental Accounting (NCGA) Statement 1 states that agency funds are purely custodial. In those cases in which a recipient government serves only as a cash conduit, the grant should be reported in an agency fund. Pass-through grants with administrative or direct financial involvement should be recognized as revenue and expenses proprietary or trust fund of the recipient government.

The GASB Statement 24 does not require that a recipient government's payment of administrative costs (indirect financial involvement) be separately evaluated in determining the reporting of pass-through grants. If a recipient government serves only as a cash conduit, it may incur some incidental administrative costs. If a recipient government's administrative costs are more than incidental that would be the result of administrative involvement.

Districts cooperate under certain conditions with other local governments. The basis is for mutual advantage to provide services and facilities. This is accomplished in a manner and pursuant to forms of governmental organization that will accord best with geographic, economic, population, and other factors influencing the needs and development of local communities.

All cooperative efforts created by the state law can be joint ventures (see Joint Venture subsection). All joint ventures are either joint operating agencies or contracted interlocal agreements. Specific laws dictate other limitations or requirements, depending on the purpose and entity. Descriptions of some cooperative efforts are as follows.

Joint Operating Agencies (Chapter 43.52 and 54.44 RCW)

A joint operating agency (JOA) is a legal entity created between any two or more cities or public utility districts. This agency is a municipal corporation of the state of Washington. The joint operating agency has authority to enter into contracts involving electric energy, fisheries, flood control, and natural resources.

Management and control of a JOA vests with the board of directors. The directors are appointed by the legislative body of each member of the JOA.

For accounting treatment, joint operating agencies should be treated as a public utility district (RCW 43.52.391).

For guidelines and requirements, see Chapter 43.52 RCW for operating agencies and Chapter 54.44 RCW for nuclear power plants.

Interlocal Agreements (RCW 39.34)

An interlocal agreement is a contract entered into between two or more public agencies for joint or cooperative action. This action must be a power, privilege, or authority already capable of being exercised by the public agencies involved, and the manner of financing should be as provided by law. The agreement could establish a separate entity as described below.

If the interlocal agreement establishes a separate legal or administrative entity, this entity must be legally created (Insurance Boards RCW 48.62.041-.101, Irrigation Districts RCW 87.03.018, Hydroelectric Resources RCW 87.03.828). The agreement must specify duration, organization, purpose, way of financing and methods of termination. Funds of this separate entity would be subject to audit in the manner provided by law for the auditing of public funds.

If the interlocal agreement does not establish a separate legal entity by law, the agreement must specify the criteria listed above and must also provide for an administrator or a joint board responsible for administering the cooperative undertaking. Provisions are also required to detail the manner of the joint board in acquiring, holding, and disposing of real and personal property used in the joint undertaking. The joint board is also authorized to establish an operating fund with a county, city, or district treasurer of one of the involved public agencies.

The interlocal agreement is filed with the county auditor, and if applicable, a state officer or agency with statutory powers of control.

Chapter 39.34 RCW contains various guidelines and requirements applicable to interlocal agreements.

For accounting treatment, an interlocal agreement must be evaluated for each member agency to determine whether joint venture treatment is applicable. If joint venture treatment is applicable, see the accounting treatment as recommended in the joint venture subsection. If joint venture treatment is not applicable, interlocal agreement should be footnoted and accounted for in an appropriate fund. Contractual requirements take precedence over accounting requirements (i.e., a contract may require one member to be reporting entity when it does not exercise "oversight responsibility").

Accounting Procedures for the Joint Ventures

GASB Statement 14, *The Financial Reporting Entity* defines the joint venture as a legal entity or other organization that results from a contractual agreement and is owned, operated, or governed by two or more participants as a separate and specific activity subject to joint control, in which the participants retain an ongoing financial interest or an ongoing financial responsibility.

> Joint control means that no single participant has the ability to unilaterally control the financial or operating policies of the joint venture.
>
> Ongoing financial interest means an equity interest or any other arrangement that allows a participating government to have access (directly or indirectly) to joint venture's resources.
>
> Ongoing financial responsibility means that the participating government is obligated in some manner for the debts or the funding of the joint venture.

Lack of the ongoing financial interest or the ongoing financial responsibility designates the entity as a jointly governed organization, subject to different disclosure requirements.

When the number of participants in joint ventures increases their financial responsibility may decrease. The Statement 14 does not establish any break point for the determination if the participant is financially responsible or not. A decision, in the marginal cases, is left to the professional judgment of the government.

For financial reporting purposes there are two types of joint ventures:

1. Joint ventures whose participants have equity interest,
2. Joint ventures whose participants do not have equity interest.

The indication of an equity interest is an ownership of shares of the joint venture's stock or other explicit and measurable rights to net resources (usually based on investment of financial or capital resources in the joint venture). To be considered explicit and measurable the rights to the present or future claims to the joint venture's resources and the methods to determine the amounts have to be clearly defined in the joint venture agreement. If equity interest in the joint venture is implied rather than explicitly stated the joint venture participants should consider modifying the agreement to clarify its intent.

Reporting Equity Interest in Joint Venture:

The proper accounting and financial reporting for joint ventures depends on whether the underlying contract creates an explicit, measurable equity interest in some or all of the joint venture's resources. If there is an explicit, measurable equity interest in the joint venture, the district's investment in the joint venture should be reported in the district's financial statements.

The *Investment in Joint Venture* account should report the district's equity interest calculated in accordance with the joint venture agreement. Initially, the investment in the joint venture should be reported at cost. If the joint venture agreement provides for the participating district to share the operating results of the joint venture, the equity interest should be adjusted for the participant's share of the joint venture's change in net assets, regardless of whether the amount was actually remitted. In calculating the participant's share of the change in net assets of the joint venture, any profit on the operating transactions between the district and the joint venture or capital contributions from the participants should be eliminated. Nonoperating transactions between the joint venture and the district should be reported in the joint venture's statement of the revenues, expenses, and changes in net assets. The equity interest should be reported in the district's statement of net assets as a single amount, and the district's share of the joint venture's change in net assets should be reported in the statement of revenues, expenses, and changes in net assets as a single amount.

Examples

The following examples illustrate how the provisions of the GASB Statement 14 would be applied to a particular set of hypothetical circumstances.

Example 1. Windfarm

Facts: The windfarm was created jointly as a separate legal entity by two districts. At inception, District A contributed 60 percent and District B contributed 40 percent of the initial capital (to purchase land). The districts jointly issued construction revenue bonds and facility revenue bonds to finance construction of the windfarm. The construction and facility bonds are payable solely from and secured by district revenues. The districts are not obligated in any manner for the windfarm debt. The initial capital investments of the two districts are to be returned to the districts by the windfarm over a period of time not to exceed fifteen years.

The windfarm is governed by a ten-member board composed of the commissioner of each district; three members of District B's commissioners and five members of District A's board. Despite the numerical imbalance of the board, the joint venture agreement provides for joint control; that is, both districts must approve the budget, the issuance of debt, and other significant activities.

The districts individually have executed covenants, by ordinance, to levy a tax (subject to rate limitations) if necessary to insure that the windfarm will be operated and maintained efficiently. To date, no tax has been levied by either district, and the windfarm has generated sufficient revenues to make annual payments to the districts in accordance with the repayment agreement for their initial capital contributions.

Conclusions: The windfarm authority is a joint venture because it was created as a separate legal entity and both districts have on ongoing financial responsibility for the entity. The fact that District A appoints a numerical majority of the windfarm's board is negated by the two districts' agreement for joint control of the windfarm. The initial capital contributed by the districts has the characteristics of an equity interest, but the agreement with the windfarm, in effects, converts the equity interest to a long-term receivable. Therefore, rather than reporting an equity interest in the joint venture, the districts would report a receivable in the fund that receives the annual payments from the windfarm. The districts do, however, have ongoing financial responsibilities for the windfarm because they have obligated themselves to fund the deficits of the windfarm by agreeing to levy tax if needed. The districts would make the required joint venture disclosure.

Example 2: Municipal Electric Authority

Facts: Eighteen small districts have formed an electric authority as a public corporation according to state law. The purpose of the authority is to enable small districts to efficiently finance, construct, and operate electric power generation and transmission facilities. Each participating district appoints one member to the authority's governing board. Construction of the authority's facilities was financed by revenue debt of the authority. None of the participants is in any way liable for the authority's debt. The authority bills each participant for usage at rates that are calculated to cover the authority's "cost" as defined in the bond indenture. The rates are structured to systematically provide cash for debt requirements, operating expenses (excluding depreciation and amortization), and reserves as specified by the bond indentures. Each district is bound by contract with the authority to annually purchase a minimum number of kilowatt-hours. The contracts are renewable at the districts: option every three years. Except for the minimum purchase contracts, no participant has any other obligation, entitlement, or residual interest. The authority is financially self-sufficient.

Conclusion: participants should report the authority as a jointly governed organization. None of the participating districts has an ongoing financial interest, and because of the large number of participants the districts: purchase contracts with the authority do not represent ongoing financial responsibilities.

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Each municipal corporation should, by action of its legislative body, authorize investment of any money which are not required for immediate expense and which are in the custody of the county treasurer or other municipal corporation treasurer.

All local governments (counties, cities, towns, special purpose districts, political subdivisions, municipal corporations, or quasi-municipal corporations, including any public corporation, authority, or other instrumentality created by such an entity) in Washington State are empowered by statute to invest money, which are eligible for investment[1], in the following types of securities. (The enabling legislation is contained in Chapter 39.59 RCW.[2])

- Certificates, notes, bonds or other obligations of the United States or its agencies, or of any corporation wholly owned by the government of the United States:

  # Treasury bills
  # Treasury bonds
  # Government National Mortgage Association bonds.
  # Small Business Administration bonds (see caution 3). (RCW 36.29.020, 43.84.080)

- State, county, municipal, or school district bonds, or warrants of taxing districts of the state. Such bonds and warrants should be only those found to be within the limit of indebtedness prescribed by law for the taxing district issuing them and to be general obligations. (RCW 36.29.020, 43.84.080)

- Motor vehicle fund warrants when authorized by agreement between the state treasurer and the Department of Transportation requiring repayment of invested funds from any money in the motor vehicle fund available for state highway construction. (RCW 36.29.020, 43.84.080)

- Federal Home Loan Bank notes and bonds. (RCW 36.29.020, 43.84.080)

- Federal Land Bank bonds. (RCW 36.29.020, 43.84.080) Federal National Mortgage Association notes, debentures and guaranteed certificates of participation. (RCW 36.29.020, 43.84.080)

- Obligations of any other government sponsored corporation whose obligations are or may become eligible as collateral for advances to member banks as determined by the board of governors of the Federal Reserve System.

  # Federal Farm Credit Banks consolidated system-wide bonds and discount notes.
  # Federal Home Loan Mortgage Corporation bonds and discounts notes.
  # Student Loan Marketing Association bonds and discounts notes.
  # Export-Import Bank bonds.
  # Maritime Administration bonds. (RCW 36.29.020, 43.84.080)

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1 Not all-available money is eligible for investment as allowed by Chapter 39.59 RCW. The Attorney General (AG) Opinion No. 132 (1961-62) states that the county general (current expense) fund's money must be in the form of cash or Athat which is redeemable in cash upon demand, as a matter of fixed right.@ The AG Memorandum to the State Auditor dated March 20, 1989, reaffirms this opinion. Warrants are not demand instruments. They are not considered to be the equivalent of cash, redeemable upon demand, as matter of right, therefore county general (current expense) fund's money cannot be invested in them.

2 Chapter 39.59 RCW expands the investment authority of local governments by allowing them to invest in Aany investments authorized by law for the treasurer of the state of Washington or any local government of the state of Washington other than a metropolitan municipal corporation . . @ (RCW 39.59.020(4)). The AG memorandum to the State Auditor dated November 30, 1989, clarifies the scope of this increased authority. It states that if a certain type of investment authority did not exist for local governments prior to the enactment of RCW 39.59.020, but was authorized by section (4) of that statute, the restrictions contained in sections (1), (2), and (3) of the statute do not apply to those newly granted powers of investment. Therefore, local governments may choose the least restrictive investments from the above list of authorized investments. (See caution 4.)

- Banker's acceptances purchased on the secondary market. (RCW 36.29.020, 43.84.080)

- Negotiable certificates of deposit of any national or state commercial or mutual savings bank or savings and loan association doing business with the United States. The investment should meet the criteria set by the State Investment Board. (RCW 36.29.020, 43.84.080)

- Commercial paper. The investment should meet the criteria set by the State Investment Board. (RCW 36.29.020, 43.84.080)

- Washington State Housing Finance Commission bonds. (RCW 43.180.190)

- Farm ownership and soil and water conservation loans fully guaranteed as to principal and interest under the Bankhead-Jones Farm Tenant Act and the Washington Land Bank. (RCW 43.33A.080)

- Bonds of the state of Washington and any local government in the state of Washington, which bonds have at the time of investment one of the three highest credit ratings of a nationally recognized rating agency. (RCW 39.59.020(1))

- General obligation bonds of a state other than the state of Washington and general obligation bonds of a local government of a state other than the state of Washington, which bonds have at the time of investment one of the three highest credit ratings of a nationally recognized rating agency. (RCW 39.59.020(2))

- Registered warrants of a local government in the same county as the government making the investment, subject to compliance with RCW 39.56.030. (RCW 39.59.020(3))

- Any investments (e.g., certificates of participation) authorized by law for the treasurer of the state of Washington or any local government of the state of Washington other than a metropolitan municipal corporation but, except as provided in Chapter 39.58 RCW, such investments should not include certificates of deposit (CD) of banks or bank branches not located in the state of Washington. (See caution 4.) (RCW 39.59.020(4))

- Revenue bonds and notes issued by port districts under the authority of Chapter 54.34 RCW. (RCW 53.34.150)

- Selected mutual funds and money market funds. They are allowable investments <u>only</u> for money subject to federal arbitrage statutes and regulations (i.e., IRC Section 148).

  # Mutual funds with portfolios consisting of only United States government bonds or United States government guaranteed bonds issued by federal agencies with average maturities of less than four years, or bonds described in RCW 39.59.020 (1) or (2), except that those bonds should have one of the four highest credit ratings of a nationally recognized rating agency;
  # Money market funds with portfolios consisting of only bonds of states and local governments or other issuers authorized by law for investment by local governments, which bonds have at the time of investment one of the two highest credit ratings of a nationally recognized rating agency;
  # Money market funds with portfolios consisting of securities otherwise authorized by law for investment by local governments. (See caution 4.) (RCW 39.59.030)

- Notes or bonds secured by mortgage (insured or with a commitment to insure in obligations of national mortgage associations) by the Federal Housing Administrator. (RCW 39.60.010)

- Debentures issued by the Federal Housing Administrator. (RCW 39.60.010)

- Bonds of the Home Owner's Loan Corporation or any other corporation, which is or may be created by the United States as a governmental agency or instrumentality. (RCW 39.60.010)

- Notes, bonds, or debentures of savings and loan associations, banks, mutual savings banks, savings and loan service corporations operating with approval of the Federal Home Loan Bank, and corporate mortgage companies that are rated not less than AA@ by a nationally recognized rating agency, or are insured or guaranteed and backed as required by the statute. (RCW 39.60.050)

- Bonds or warrants of the state of Washington. (RCW 35.39.030)
- General obligation or utility revenue bonds or warrants of any city or town in the state of Washington. (RCW 35.39.030)
- Bonds or warrants (RCW 35.39.030) or installment notes (RCW 35.45.150) of a city's or town's own local improvement district, which are within the protection of the local improvement guaranty fund law.
- Interim financing warrants of a local improvement district, which is within the protection of the local improvement guaranty fund law for the benefit of the general (current expense) fund. (RCW 35.39.034)
- Bonds or other obligations issued by a metropolitan municipal corporation pursuant to Chapter 35.58 RCW. (RCW 35.58.510)
- Outstanding warrants of the county tax refund fund in the same county as the government making the investment subject to the provisions of RCW 36.33.070.
- Bonds or other obligations issued by a housing authority pursuant to the housing authorities law of this state or issued by any public housing authority or agency in the United States. (RCW 35.82.220)

NOTE: Per an Attorney General Memorandum dated February 8, 1991, cities and towns have the authority to invest in out-of-state CDs via RCW 35.39.030(6) and RCW 43.84.080(6). Restrictions on investments contained in RCW 39.59.020 do not apply to investment authority existing prior to the enactment of that statute (1988). Accordingly, local governments other than cities or towns would be restricted to investment in in-state CDs since they did not possess this authority prior to the enactment of RCW 39.59.020(4).

In addition to the securities listed above, municipalities may invest excess money in the Washington State Treasurer's Investment Pool (Chapter 43.250 RCW). The legislative body of the district must authorize participation by passing a resolution.

PUBLIC DEPOSITORIES

Except for funds deposited pursuant to a fiscal agency contract with the state fiscal agent or its correspondent bank, no public funds may be deposited in demand or investment deposits except in a qualified public depository or as otherwise permitted by statute. Total deposits of a treasurer in a depository may not exceed that depository's net worth (RCW 39.58.130).

A financial institution receives designation as a public depository from the Public Deposit Protection Commission (PDPC). This designation is readily verified, either from the institution (a letter of authority from the Commission) or from the PDPC. The PDPC publishes a quarterly list of each qualified depository and its net worth. This list will be furnished upon request by writing to:

Public Deposit Protection Commission
Office of State Treasurer
General Administration Building
PO Box 40206
Olympia, WA 98504-0206

CAUTIONS

1. Investments allowed by debt covenants may be more restrictive than statutes

   The debt covenants contained in bond indentures and the provisions of other agreements may be more restrictive than the statutes about the types of investments permitted for certain money.

2. <u>Avoid conflicts with the laws of other states</u>

Some corporations have sold instruments in Washington, which require the issuer or holder to comply with laws of other states. It is questionable whether it is prudent or appropriate for a public treasurer in Washington to enter into such agreements.

3. <u>SBA loans are inherently risky</u>

In order for a business to qualify for a Small Business Administration (SBA) loan, it must usually have been unable to obtain credit at a financial institution. Hence, SBA obligations backed by SBA loans have weaker underlying credit than the standards in the money market. Although the federal government guarantees these loans, default does not result in immediate liquidation. Some SBA investors are holding paper while the loan is "worked out." Also, federal guarantees do not extend to points paid.

4. <u>State Constitution prohibits some investments</u>

Article VIII, Sections 5 and 7, and Article XII, Section 9 prohibit the state and local governments in the state from extending credit, giving money or property, or loaning money to individuals, associations, companies, or corporations. Therefore, except for the following exceptions, treasurers should not invest in stock of private companies or other investments, which appear to be prohibited. Article XXIX, Section 1, provides that public pension, retirement, and industrial insurance trust funds be the <u>only</u> exceptions, thus allowing any investment authorized by law. Any investment holdings in violation of the Constitution will be challenged.

5. <u>PDPC covers losses as provided by statute</u>

All public deposits in qualified public depositories are protected from loss as provided in Chapter 39.58 RCW, but there are some limitations. In the event of a loss due to default of a qualified public depository, the PDPC would:

a. Determine the net deposit liability of the defaulting institution after the FDIC coverage.

b. Make assessments against all bank depositories <u>or</u> all thrift depositories, depending on whether the defaulting institution was a bank or a thrift institution:

- First, against the defaulting institution to the full extent of securities pledged as collateral.
- Second, against all other bank or thrift depositories, for their proportionate share of the loss, up to a maximum of 10 percent of each institution's public deposits. (RCW 39.58.060(3); 39.58.010(6).)

c. Represent all public treasurers for liquidation of the defaulting institution's assets to recover the remaining net deposit liability, if any exists after assessments against all bank or thrift depositories.

Treasurers should be aware that in the event of a default of a qualified depository, the funds in that institution could be tied up until deposit balances are certified and assessments are collected (RCW 29.58.060). Diversification of investments among various bank and thrift institutions could help alleviate potential cash flow problems.

6. <u>Properly name accounts for insurance coverage</u>

In order to maximize insurance coverage from the FDIC care should be exercised to properly name deposit accounts so that ownership of such accounts is clear.

7. <u>Consult your bond counsel for guidance on arbitrage restriction</u>

The Tax Reform Act of 1986 placed tighter restrictions on tax-exempt bonds. Penalties for noncompliance include fines and, possibly, retroactive taxation on the bonds.

8. Repurchase agreements require proper procedures to avoid loss

Recent losses suffered by local governments indicate the need for treasurers to participate in repurchase agreements (repos) with adequate procedures and knowledge of the mechanics of repo transactions.

a. Treasurer must have control of securities in repos

Each repo must be structured so that one of the following events occurs for the period of time that the repo is effective:

(1) Either of the procedures called DVP (delivery versus payment) whereby:

a) The treasurer obtains physical delivery of the underlying securities; or
b) The underlying securities are delivered to a third party, such as a safekeeping bank acting as an agent for the public treasurer; or

(2) The underlying securities are delivered to a bank's trust division (not within its operating division) for the account of the public treasury, when the repos are being done with the same institution.

This delivery may be made either physically or by book entry. Book entry is a system of handling securities. The Federal Reserve Bank's system is a securities safekeeping arrangement between the Fed and its customers. All U.S. government agencies= issues exist only in book entry form, in computerized files, rather than in definitive (engraved paper) form. Under the system, book entry securities are transferred electronically between accounts based on input from the depository institution transferring securities from its account.

b. Do not invest in "pooled" or "master" repos

Some dealers offer repos where a treasurer invests in a pool of securities held by a trustee. Statements from the trustee list the securities; however, no Aowner@ is listed on the statement. The statements only reference a pool number. Treasurers have no way to assure themselves that the dealer has not oversold the securities. In the event of a dealer's default, the treasurer may discover the pool does not cover all of the claims of its investors. Where trustees or a bank's trust division is holding securities involved in repos, the treasurer must require that the securities be held in his/her name.

c. Market value of securities should cover the investment

Treasurers should assure themselves that they are adequately protected from a sudden decline in the market value of the securities they have purchased. Some authorities recommend that the market value of the underlying securities exceed the amount to be received at the end of the agreement, thus protecting principal and interest. It is common practice in the industry for an excess of market value over the cash paid, called a market or "haircut", to be built into the agreement to protect against declines in the market value of the underlying securities.

The local treasurer should review (reprice) the market value of the underlying securities periodically to make sure it has not fallen below an acceptable level, placing part of the government's principal and earnings at risk. Should such a decline in value occur, additional securities should be obtained or part of the government's principal should be recovered. The size of the margin built into the agreement should reflect the price volatility of the underlying securities, the frequency of repricing, and the length of the repos.

d. Evaluate financial position of security dealers

Treasurers should screen and evaluate the integrity of dealers from whom they will purchase securities. Many dealers are unregulated. Many authorities recommend that treasurers deal only with the primary security dealers. Dealers of money market or mutual funds must have bonds posted with the Risk Management Office of the Department of General Administration per RCW 39.59.010.

e. Obtain written contracts

Local governments should establish their rights in repos through written contracts. A written contract will specify, among other things, the right of the district to liquidate the underlying securities in the event of default by the dealer and directions for the delivery of the underlying securities. This written contract may take the form of a master agreement covering all future transactions or a transaction agreement covering a single transaction.

Districts should also have a written contract with a custodial agent, usually a bank, specifying the responsibilities of that third party. Such a written contract, called a custodial agreement ensures that the district's custodian is an independent third party to the repo transaction. Among the custodial responsibilities that may be specified in a written contract are:

1) The custodian's responsibility to disburse cash for repos only on delivery of the underlying securities;
2) The custodian's responsibility to obtain additional securities if the required margin on the repo agreement is not maintained;
3) The custodian's responsibility for periodic reporting to the district on the market value of the securities.

f. Beware of pitfalls

No treasurer should participate in repos without a thorough knowledge and understanding of what repos are and how they work. Every treasurer should be aware of the pitfalls and why other governments have suffered losses.

NOTE: The BARS material on investments is intended to inform local treasurers of the State Auditor's current audit standards and to provide information on current legal authority questions and on prudent investment standards. This material does not constitute a legal opinion on the validity of any particular investment. The State Auditor does not intend to imply that a treasurer who follows the standards set forth in these materials will thereby avoid any possibility of a loss of public funds. Each treasurer must exercise his/her best professional judgment in selecting particular investments, relying where appropriate on legal and other professional assistance.

INVESTMENT RECORD

Line No.	Date Purchased	Description	Purchase Price	Date Sold	Sales Price	Receipt Number	Investment Fee	Interest Earnings	To Be Remitted to Beneficial Owner	To Be Remitted to Treasurer	Investment Balance		Line No.
											Debit	Credit	

Many districts have agreed to maintain a predetermined average daily balance in noninterest bearing bank accounts to compensate banks for handling the district's bank services. In many cases, there is no rational relationship between the interest, which the district would have earned on the deposit, and the amount that would have been paid for bank services.

In the event a decision is made to maintain a compensating balance, the district should:

- Obtain proposals on bank service charges from several banks.
- Document with historical and statistical evidence that the interest foregone is substantially equivalent to or less than the proposed bank service charges.

When a public utility levies taxes for operating purposes, general obligation bond redemption, or capital construction, a receivable should be recognized.

Utilities should provide a general ledger account for *Taxes Receivable*. If utilities use another prescribed system, such as Federal Energy Regulatory Commission (FERC) or National Association of Regulatory Utility Commissioners (NARUC), and do not have a taxes receivable account, they are advised to use a general ledger account *Other Accounts Receivable*.

In all systems of accounts, the taxes levied for operating purposes should be shown as nonoperating revenue on the operating statement. Taxes levied for general obligation bond redemption are for principal and interest. The interest portion is shown as nonoperating revenue and the principal portion is treated as a reduction in the payable.

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Capital assets are tangible and intangible assets that are used by the district and have initial useful lives extending beyond a single reporting period. Examples of capital assets include:

- Land and improvements to land (includes right-of-way and easements),
- Buildings and building improvements,
- Parking lots,
- Vehicles,
- Machinery and equipment,
- Works of art and historical treasures,
- Infrastructure assets, and
- Other tangible and intangible assets that are used by the district.

Works of art, historical treasures and similar assets are considered to be capital assets and as such they should be capitalized at their historical cost or fair market value at the date of donation. The exhaustible assets should be depreciated over their useful lives. Districts should not report depreciation for collections or items that are inexhaustible (i.e., the individual works of art or historical treasures that have extraordinary long useful lives). Distinctions of exhaustible and inexhaustible items or collections, or their useful lives need to be made by each district. Depreciation is not required for inexhaustible items or collections.

Collections, which meet the following requirements, are not capitalized and depreciated:

1. They are held for public exhibition, education, or research in furtherance of public service rather than financial gain;
2. They are protected, kept unencumbered, cared for, and preserved; and,
3. They are a subject to an organizational policy that requires the proceeds from sales of collection items to be used to acquire other items for the collection.

Districts should disclose information about their works of art and historical treasures in the notes to their financial statements.

For purposes of this section, the term *accounting* is limited to the procedures of keeping books and preparing financial reports; accounting is one way, but by no means the only way, of demonstrating accountability.

Accountability means the obligation to demonstrate good management of or control over those matters for which a person or agency is responsible. The districts are accountable for a lot more capital assets than they may ever account for. For example, districts do not account for the value of their small assets but they are accountable for these assets.

A *capital assets management system* is the set of policies and procedures used to control district's capital assets. The system should satisfy accounting/reporting requirements and it should demonstrate accountability for the capital assets.

Specific requirements of the State Auditor' Office are contained in subsequent sections of this chapter. In addition, the federal government has issued property management requirements, which apply to all governments that receive federal assistance. Each federal agency has published a *Federal Agency Implementation of the Common Rule*. Excerpts from the Common Rule have been included in this section. Note that these requirements involve broad stewardship responsibilities and specific accounting records.

The duty to make certain that public property is adequately protected and that its use is properly managed is one of the fundamental responsibilities of public officials. For some types of local governments, the statutes are quite specific about the things that public officials have to do to demonstrate their stewardship of public property. But regardless of whether or not the statutes for the particular government identify any specific duties, public officials have several broad responsibilities with respect to capital assets; these are custody, insurance, maintenance and planning.

Custody

The responsibility for custody means having the answers to such questions as:

> What property and equipment does this district own?
> Where is it?
> What condition is it in?
> Is it protected from loss and unauthorized use?

Insurance

The second major responsibility for capital assets is providing adequate insurance. A capital asset accounting system should provide adequate records to prove any losses. Location, inventory, and maintenance records will confirm that a lost or damaged asset has been in use recently, which will support the validity and timeliness of a theft or damage report. In addition, when a district has elected to self-insure to some degree, the officials should obtain an independent evaluation of the extent of the risk that has been assumed, which cannot be done without knowing what assets are at risk.

Maintenance and Repair

The third major responsibility is maintenance. As a steward of public property, an official has the obligation not only to safeguard assets from loss but also to ensure they are not neglected or wasted. The district should not find itself surprised by building or equipment repair or maintenance requirements or by predictable problems with down time and availability of spare parts.

The basic requirements for demonstrating stewardship in maintaining public property are evidence that, first, the district knows what maintenance is required to preserve its assets and that it schedules that maintenance; and, second, that needed repairs are promptly identified and performed. In the area of maintenance, record keeping requirements vary according to the kind of asset and its durability. The district should have adequate historical data to make informed decisions about the costs of certain levels of maintenance or intentional neglect.

Planning

The fourth general category of responsibility is planning for future asset needs both short and long ranges. Here you need answers to questions such as:

> How well is the district using the facilities and equipment it already has?
>
> What does the district already own that could be transferred to another facility instead of purchasing additional equipment?
>
> Which items must be replaced, when and at what cost?
>
> When will additional facilities or equipment be needed, where and at what cost?
>
> Which facilities or equipment will not be needed, and what cost reductions in maintenance, insurance, and security will result from liquidating them?

The extent and nature of capital planning will vary a great deal, depending on such factors as the size of the district, whether demand for its services is stable or changing, whether its functions are capital intensive (like public works and utilities) or labor intensive (like education and welfare services), and how capital outlays are funded (through rates, general taxes, special bond issues, or grants).

<u>Federal Common Rule Excerpts for Property Management</u>

1. All federal agencies administering programs that involve grants are to issue a common grants management rule (Common Rule). The excerpts listed below are the general rule, however some agencies may publish deviations from the Common Rule due to statutory requirements.

2. <u>Real Property</u>

   a. **Title**. Subject to the obligations and conditions set forth in this section, title to real property acquired under a grant or subgrant will vest upon acquisition in the grantee or subgrantee respectively.

   b. **Use**. Except as otherwise provided by federal statutes, real property will be used for the originally authorized purposes as long as needed for that purposes, and the grantee or subgrantee shall not dispose of or encumber its title or other interests.

   c. **Disposition**. When real property is no longer needed for the originally authorized purpose, the grantee or subgrantee will request disposition instructions from the awarding agency. The instructions will provide for one of the following alternatives:

      (1) **Retention of title**. Retain title after compensating the awarding agency. The amount paid to the awarding agency will be computed by applying the awarding agency's percentage of participation in the costs of the original purchase to the fair market value of the property. However, in those situations where a grantee or subgrantee is disposing of real property acquired with grant funds and acquiring replacement real property under the same program, the net proceeds from the disposition may be used as an offset to the cost of the replacement property.

      (2) **Sale of property**. Sell the property and compensate the awarding agency. The amount due to the awarding agency will be calculated by applying the awarding agency percentage of participation in the cost of the original purchase to the proceeds of the sale after deduction of any actual and reasonable selling and fixing-up expenses. If the grant is still active, the net proceeds from sale may offset against the original cost of the property. When a grantee or subgrantee is directed to sell property, sales procedures shall be followed that provide for the competition to the extent practicable and result in the highest possible return.

      (3) **Transfer of title**. Transfer title to the awarding agency or to a third party designated/approved by the awarding agency. The grantee or subgrantee shall be paid an amount calculated by applying the grantee or subgrantee's percentage in participation in the purchase of the real property to the current fair market value of the property.

3. <u>Equipment</u>

   a. **Title**. Subject to the obligations and conditions set forth in this section, title to the equipment acquired under a grant or subgrant will vest upon acquisition in the grantee or subgrantee respectively.

   b. **Use**.

      (1) Equipment should be used by the grantee or subgrantee in the program or project for which it was acquired as long as needed, whether or not the project or program continues to be supported by federal funds. When no longer needed for the original program or project, the equipment may be used in other activities currently or previously supported by a federal agency.

      (2) The grantee or subgrantee shall also make equipment available for use on other projects or programs currently or previously supported by the Federal Government, providing such use will not interfere with the work on the projects or program for which it was originally acquired. First preference for other use shall be given to other programs or projects supported by the awarding agency. User fees should be considered if appropriate.

(3) The grantee or subgrantee must not use equipment acquired with grant funds to provide services for a fee to compete unfairly with private companies that provide equivalent services, unless specifically permitted or contemplated by federal statute.

(4) When acquiring replacement equipment, the grantee or subgrantee may use the equipment to be replaced as a trade-in or sell the property and sell the property and use the proceeds to offset the cost of the replacement property, subject to the approval of the awarding agency.

c. **Management requirements**. Procedures for managing equipment (including replacement equipment), whether acquired in whole or in part with grant funds, until disposition takes place will, as a minimum, meet the following requirements:

(1) Property records must be maintained that include:

(a) a description of the property
(b) a serial number or other identification number
(c) the source of property
(d) who holds title
(e) the acquisition date and cost of the property
(f) percentage of federal participation in the cost of the property
(g) the location, use and condition of the property
(h) any ultimate disposition data including the date of disposal and sales price of the property.

(2) A physical inventory of the property must be taken and the results reconciled with the property records at least once every two years.

(3) A control system must be developed to ensure adequate safeguards to prevent loss, damage, or theft of the property. Any loss, damage, or theft shall be investigated.

(4) Adequate maintenance procedures must be developed to keep the property in good condition.

(5) If the grantee or subgrantee is authorized or required to sell the property, proper sales procedures must be established to ensure the highest possible return.

d. **Disposition**. When original or replacement equipment acquired under a grant or subgrant is no longer needed for the original project or program or for other activities currently or previously supported by a federal agency, disposition of the equipment will be made as follows:

(1) Items of equipment with a current per-unit fair market value of less than $5,000 may be retained, sold or otherwise disposed of with no further obligation to the awarding agency.

(2) Items of equipment with a current per-unit fair market value in excess of $5,000 may be retained or sold and the awarding agency shall have a right to an amount calculated by multiplying the current market value or proceeds from sale by the awarding agency share of the equipment.

(3) In cases where a grantee or subgrantee fails to take appropriate disposition actions, the awarding agency may direct the grantee or subgrantee to take excess and disposition actions.

e. **Federal equipment**. In the event a grantee or subgrantee is provided federally owned equipment:

(1) Title will remain vested in the federal government.

(2) Grantees or subgrantees will manage the equipment in accordance with federal agency rules and procedures, and submit an annual inventory listing.

(3) When the equipment is no longer needed, the grantee or subgrantee will request disposition instructions from the federal agency.

f. **Right to transfer title**. The federal awarding agency may reserve the right to transfer title to the federal government or a third party named by the awarding agency when such a third party is otherwise eligible under existing statutes. Such transfers should be subject to the following standards:

(1) The property shall be identified in the grant or otherwise made known to the grantee in writing.

(2) The federal awarding agency shall issue disposition instructions within 120 calendar days after the end of the federal support of the project for which it was acquired. If the federal awarding agency fails to issue disposition instructions within the 120-calendar-day periods the grantee shall follow the proceeding guidelines provided in *Disposition*, (subsection d).

(3) When title to equipment is transferred, the grantee shall be paid an amount calculated by applying the percentage of participation in the purchase to the current fair market value of the property.

5. Supplies

a. **Title**. Title to supplies acquired under a grant or subgrant will vest, upon acquisition, in the grantee or subgrantee respectively.

b. **Disposition**. If there is a residual inventory of unused supplies exceeding $5,000 in total aggregate fair market value upon termination or completion of the award, and if the supplies are not needed for any other federally sponsored programs or projects, the grantee or subgrantee shall compensate the awarding agency for its share.

6. Copyrights

The federal awarding agency reserves a royalty-free, non exclusive, and irrevocable license to reproduce, publish or otherwise use, and to authorize others to use, for federal government purposes:

a. The copyright in any work developed under a grant or subgrant; and

b. Any rights of a copyright to which a grantee, subgrantee or a contractor purchases ownership with grant support.

Designing and establishing a capital asset system requires systematic planning. These plans fall into three basic areas:

1. Establishing the objectives of the capital asset system and making permanent policy decisions, which will shape both the initial establishment of, capital asset inventory and maintenance of the system.

2. Designing the plan for taking the initial inventory, for verifying and testing the data, and for establishing a value for each recorded asset.

3. Determining when and how to implement controls over additions and deletions to the capital asset inventory.

An adequate capital asset accounting system should enable the district to meet statutory requirements, to produce adequate records and reports, and to safeguard assets properly.

The basis of a capital asset accounting system is the individual capital asset record. It is necessary to apply careful thought to designing the capital asset record so that the district can accumulate the information it will want later on. Generally it is too costly to reconstruct this data at a later date. The sample format illustrated in this chapter has been designed to collect most of the important data about capital assets; however, not all of this information is mandatory. The following minimum information is required for all capital assets. Sections F and G identify additional requirements for infrastructure and internal service fund capital assets.

1.	Category of asset, custody and general ledger asset account.	(Boxes 1 - 5)
2.	Acquisition information, including reference to source documents and acquisition dates.	(Boxes 6a - 6c)
3.	Changes in custody or use.	(Boxes 2 and 6a - 6c)
4.	Source of payment (fund, grants, etc.), historical cost, and account numbers.	(Boxes 6d - 6f)
5.	Description of asset, including legal descriptions where applicable.	(Box 7)
6.	Disposition information.	(Box 14)

Other information that is desirable, but not mandatory, includes the following:

1. Brief directions on where/how to locate the asset.
2. Special insurance, maintenance, and repair instructions.
3. Class code or location code if used.
4. Physical inspection dates and condition of asset when it was inspected.

The areas left blank on the sample format (items 8, 12 and 13) are used in different ways depending on the type of asset recorded.

This format can be used for two different purposes:

1. In a small system the individual records can serve as the subsidiary ledger to support capital asset general ledger accounts as well as providing the other data needed for proper management of capital assets. These records are designed for use as a subsidiary ledger. Account number and name, cost and depreciation information are all in the same place on each form for ease in sorting and totaling. If the records are used as a subsidiary ledger, they must be numerically controlled.

2. For automated systems, these records can be used as input documents or as a guide for the data fields to design into a computerized capital asset subsidiary ledger.

1. ASSET TYPE:	2. Custody/Assignment:
ID No.:	3. Fund:
4. ASSET ACCOUNT NAME:	5. ASSET ACCOUNT NUMBER:

6. CUMULATIVE COST HISTORY

a. Acquisition/ Disposal Date	b. Doc. Date	c. Doc. No.	d. Source of Payment	e. Acct. No.	f. Cost

7. GENERAL DESCRIPTION

8.

9. SPECIAL INSURANCE, MAINTENANCE, REPAIR, ETC., INSTRUCTIONS

10. CUMULATIVE DEPRECIATION/DEPLETION

(Estimate Asset Life = _____ years)

a. Date	b. Doc. No.	c. Current Year	d. Cumulative

11. PHYSICAL VERIFICATION					
a. Date	b. Comments	c. Conditions	a. Date	b. Comments	c. Conditions

12.

13.	14. ASSET DISPOSAL INFORMATION
	a. Sold/Traded to: b. Disposition Date: c. Receipt No.: d. Disposition Authorization: (1) Date (2) Source e. Proceeds of Sale/Insurance Claim f. Less: Net Book Value (____________________) g. Gross Gain (Loss) h. Less: Amount Due to Grants (____________________) i. Net Gain (Loss) =================== j. Grantor Notification Date: k. Grantor Disposal Instructions:

Once the capital asset system is in operation, the district needs to make sure that assets, which should be capitalized, are properly recorded and that records are brought up to date when assets are disposed. Use of a standard form assures that the information needed for recording capital asset transactions is promptly collected and processed. A sample form for this purpose is contained in Chapter 6, Section C. In addition, periodic physical inventories must be taken to verify the existence and condition of the assets. These inventories must be reconciled to capital asset records and reports.

TRANSACTIONS TO RECORD

Each time the district acquires or disposes of a capital asset, transfers an asset between locations, charges depreciation expense or makes an adjustment, an entry must be made on the individual capital asset record. Internal controls must be established to insure that these transactions are properly and promptly recorded. If capital asset disposals or transfers are numerous, a capital asset journal should be used to record and control these changes. It is a good idea to always write detailed explanations of these entries, especially for disposals of assets, because it is difficult to reconstruct the circumstances of a transaction at a later date. If a capital asset journal is used, the general ledger and subsidiary capital asset accounts should be posted from this journal.

1. Capitalization policy defines what assets should be added to the system by specifying dollar limits: that policy should also specify the treatment of capital leases, procedures for accumulating costs for self-constructed assets, requirements for controlling small attractive assets that are not capitalized and accounting for infrastructure. Personnel should be thoroughly familiar with and trained to recognize and code capital outlays properly and to understand the district's capitalization policy.

2. For additions, procedures must be implemented to assure that the property systems accountant automatically receives a copy of the receiving report or the invoice. He/she should also receive a copy of all lease agreements, progress billings on construction contracts, and worksheets that itemize the costs of assets constructed in-house.

3. For deletions, procedures must be implemented to assure that the property systems accountant automatically receives all resolutions that declare property surplus, all property insurance claims, and itemized invoices for acquisitions that involve trade-ins. Oversights are difficult to avoid entirely, but they will be detected and corrected when physical inventories are taken.

4. For small attractive assets that are not capitalized, a policies and procedures manual should contain instructions for adding and deleting these assets from the control lists used to monitor them.

5. Procedures must be established to account for transfers whenever an asset changes location, custody or fund. These procedures should list the steps for preparing and approving of transfer documents and notifying the accountant responsible for maintaining the capital asset records.

6. The property accountant must perform several different reconciliations and analyses:

   a. Reconcile physical inventory to individual capital asset records (Chapter 6, Section C);
   b. Reconcile individual capital asset records to general ledger asset accounts;
   c. Reconcile capital expenses to total additions of capital assets;
   d. Analyze detail for additions to lists of not capitalized small attractive assets;
   e. Reconcile significant capital grants shown on the grant inventory with increases to the capital asset accounts.
   f. Analyze proceeds from insurance claims and sales or auction lists, claims reports, etc., to total capital asset disposals;
   g. Reconcile capital assets transferred to other locations, custody or funds with capital assets transferred from other locations, custody or funds.

COST

Original cost (historical cost) is the amount spent to acquire an asset. This cost is based on the actual price paid, including related taxes, commissions, installation costs and any other costs related to acquiring the asset or preparing the asset for use. The actual price should approximate fair market value. If the information regarding original cost is not available, the district needs to estimate the original cost.

Several unique circumstances arise when determining cost, particularly in utility accounting. The following are the more frequent accounting problems related to *cost*, but the discussion is not meant to be all-inclusive.

Excess Costs

A basic accounting concept is that capital assets should be recorded at cost. However, GAAP does provide that expenses, which do not add to the utility of an asset, should not be capitalized. For example, a cost of repair a piece of equipment that was damaged during shipment should be expensed. Each capital asset purchase should be analyzed carefully to determine which portions of the cost should be capitalized.

Similar treatment is mandated by certain regulatory agencies. For example, FERC provides that any amounts incurred for plant additions that are in excess of just and reasonable charges should be included in the account *Other Deductions*. Likewise, if excess costs are incurred to replace individual units of property damaged in a storm so as to restore the utility system to operating condition without delay, then only the normal or fair cost is charged to plant, the balance to maintenance.

Acquisition Adjustments

Original cost in the FERC accounting systems means the cost of such property to the person first devoting it to public service. When a system or plant already in operation is purchased by a utility, the FERC accounting systems require charging the difference between the cost to the acquiring utility and the *original cost* (estimated if not known and net of accumulated depreciation) to an intangible asset account *Plant Acquisition Adjustments*. Such debits would then be amortized over a period not to exceed the remaining life of the property.

Capitalization of Interest

Interest should be capitalized.

Donated Assets

Assets are sometimes donated to a district. If the donation is cash to be used in conjunction with the construction of a specific asset, the donation is reported as a capital contribution. If the asset contributed is other than cash, it should be reported at the fair market value on the date of donation.

If the asset is utility plant and the fair value exceeds *original cost*, see the Acquisition Adjustments paragraph above. Electric and gas utilities need to make a year-end adjustment for FERC reporting. (See Chapter 6, Section F, *Depreciation and Modified Approach*.)

Improvement/Repair/Maintenance Expenses

Routine repair and maintenance costs should be expensed as they are incurred. Major repairs should be capitalized if they result in betterments/improvements. The difficulty arises in the case of capital outlays that are partly replacements and partly betterments/improvements. To the extent that the project replaces the "old" part of a capital asset, outlays should not be capitalized (unless cost of the "old" part was removed from the cost of the asset); and to the extent that the project is betterment/improvement, outlays should be capitalized. The distribution of the total cost in such a case is a matter of managerial determination. When the distinction between replacement and betterment/improvement is not easily determinable, the district should expense the entire cost of the project.

When the cost of improvement is substantial or where there is a change in the estimated useful life of an asset, depreciation charges for future periods should be revised based on the new book value and the new estimated remaining useful life. No adjustment should be made to prior periods.

A physical inventory of the capital assets is necessary to verify that the assets still exist; it also provides updates on the condition of the assets. This information demonstrates that the district is exercising its custodial responsibility for the asset and is beneficial when establishing an insurance claim because it substantiates both the existence and the condition of the asset near the time of loss or damage.

The simplicity or complexity of inventory taking will depend on the district's size, the sophistication of the capital asset accounting system and the level of automation. Whatever approach the district takes, the following procedures are required:

1. Policies and Procedures. Policies and procedures governing the taking of regular physical inventories must be documented. These inventories must be taken **not less often than once a year**. The policy should state who should conduct the physical inventories, at what time of year, and what training is required for the inventory takers.

2. Develop a Work Plan. The district must centralize control over the inventory taking process and reconcile inventory records to book values. An inventory supervisor should be assigned the responsibility for developing the work plan and training and coordinating the inventory takers.

   a. The work plan should include instructions for using prelistings of existing assets. In an on-going system, this listing should be up-to-date and reasonably complete and should include both capitalized assets and small attractive assets that are not capitalized. (Variances between the prelisting and the actual inventory should be reconciled. See item 4 below.) Unless the district is very small, these prelistings should be sorted by location rather than asset type, because it is more efficient and accurate to count all assets in one location before proceeding to the next location. For larger districts, inventory takers should have building floor plans and maps to aid in identifying sites to inventory. By crossing off rooms or areas as they are completed, inventory takers can better assure that all assets were inventoried and that there have not been any duplications.

   b. The inventory takers should be trained in inventorying procedures, including what to do about items located but not on the prelisting and items on the prelisting that cannot be located. (Reconciling these add-ons/deletions must be done by the inventory supervisor or accounting department after the inventory is taken. See item 4 below.) The procedures should also explain how to evaluate and record observations about the physical conditions of assets.

   c. Districts that are using individual capital asset records as their subsidiary ledger may sort these records by location and use them as the prelisting. Inventory takers also need the listing by location of small attractive assets that are not capitalized.

3. Choice of Inventory Takers

   Ideally, the person(s) assigned custody for assets should not be the inventory taker, although the custodian should review the completed inventory. If using the custodian is the only practical means of taking inventory, then either the inventory supervisor or someone from the accounting department should spot check the inventory to test its validity. It will help assure that the inventory is carefully taken if the employees are aware that their work will be checked.

4. Reconciliation

   Once the physical inventories are complete, they must be reconciled to the individual capital asset records or the listings of small attractive assets. Since the prelistings are generated from these records, the reconciliation is limited to:

   (1) identifying those assets that were purchased or transferred-in but not added to or changed on the individual capital asset records or listings of small attractive assets, and
   (2) investigating the disposal or transfer-out of assets not located.

   There are several other reconciliations that need to be made. See Section D for a complete list.

Depreciation

Capital assets including infrastructure should be depreciated. There are some exceptions for depreciating art and historical treasures, if they are inexhaustible.

The depreciable capital assets should be reported net of accumulated depreciation. Accumulated depreciation equals total of all amounts of depreciation expense in the operating statements (from the time when a capital assets was acquired). Accumulated depreciation may be netted against capital assets and reported as a separate line on the face of financial statements or in parentheses. Regardless of a presentation method, the depreciation has to be disclosed in the notes to financial statements.

The following should be considered when recording depreciation:

1. Except for land, all capital assets must be depreciated. For quarries, timberlands, and mineral rights, depletion expenses must be recorded.

2. Scrap value can be ignored in establishing the amount to depreciate.

3. Depreciation must be based on a reasonable estimate of expected useful life; that is, the number of years, miles, service hours, etc., that the district expects to <u>use</u> that asset in operations. An asset that is surplus or that is held for possible future use is an investment and should not be depreciated.

4. Whether group-life or individual asset depreciation is used, the amount of depreciation charged must be constant for each time period (called straight-line depreciation) or for each unit of service (such as quantity of output, hours or miles of operation, etc.).

   a. Depreciation must be based on the entire cost of the asset, including any amounts contributed or donated. Depreciation rates may be set for groups of related assets (see the paragraph on group-life depreciation) or for individual assets.

   b. When depreciation charges are based on time periods, charges should be made for each month that an asset is in service. Exceptions such as the half-year convention or excluding depreciation in the first year of service are acceptable, unless capital asset additions to a fund in one year exceed 50 percent of net capital assets before the addition. When such large additions are made in one year, depreciation must be charged for no less than each whole month the additions are in service, because it is likely that material distortions in operating income would result from applying more approximate methods.

5. When assets are depreciated individually, each asset may contain components, which will have an estimated useful life considerably shorter than the asset taken as a whole. (The most common example is a building, where the roof and flooring will need replacement long before the entire structure.) While not required, the use of component depreciation for such assets is much more accurate and simpler to maintain.

6. As a district uses its capital assets, it needs to revise the expected useful lives of some of them. Any such changes should be applied prospectively; that is, the rate should be recalculated based on the remaining useful life at the time of the revision, and the new rate should be applied in the present and future accounting periods. No changes should be made to financial records of previous years for revised estimates.

Group-Life Depreciation

There are two entirely different applications of group-life depreciation. The first type is applied to a set of very similar assets acquired at about the same time, such as a suite of office furniture. For this type of group-life depreciation, the group of assets should be treated as a single asset; any gain or loss on disposal is deferred until the entire group has been retired. When some items within the group are retired ahead of schedule, the original cost of the items is removed from both the asset and the accumulated depreciation account. Depreciation continues to be charged only for the remaining assets at the original rate. This defers any gain or loss until the entire group has been retired. When some items in the group require major repair, the book value of the group should be adjusted and the periodic depreciation recalculated for the remaining life of the group.

The second type of group-life depreciation is used primarily in utilities, and it is applied to dissimilar assets, which are related by the mode of operation in which they are used. The rate of depreciation is a weighted average of the rates applicable to the individual assets, which comprise the group. The use of this method is intended to eliminate gains and losses on asset retirements, except when an entire operating system or facility is retired from service.

Depreciation on Donated Assets

Depreciation of assets acquired from contributions is calculated in the same manner as for other assets and is reported in the same way on the operating statement.

Modified Approach

Districts are allowed to report infrastructure assets using the modified approach, provided certain requirements are met. They may use this method for all or only a portion of their infrastructure assets.

There are two requirements for using the modified approach;

- The district must maintain the eligible infrastructure assets using an asset management system (see requirements below), and
- There must be documentation that the eligible infrastructure assets are being preserved approximately at (or above) a condition level established and disclosed by the district.

Under this approach only expanses for additions and improvements to eligible infrastructure assets should be capitalized on the statement of net assets (or balance sheet). The maintenance and preservation cost (preservation extends the useful life of an asset beyond the originally estimated, but does not increase its capacity or efficiency) of eligible infrastructure is expensed.

Depreciation is not calculated and reported for the eligible infrastructure assets using modified approach.

An asset management system must possess minimum the following features:

(1) Have an up-to-date inventory of eligible infrastructure assets,
(2) Perform condition assessments of the eligible infrastructure assets and summarize the results using a measurable scale,
(3) Estimate each year the annual amount to maintain and preserve the eligible infrastructure assets at the condition level established and disclosed in the financial statements.

The use of internal service funds, unless legally required, is not required by the generally accepted accounting principles (GAAP). However, GAAP permits internal service funds to be used for activities that provide goods and services to other funds or departments or other governments on the cost reimbursement basis. The use of an internal service fund is only appropriate if the sponsoring government is the predominant user of the services. Otherwise, an enterprise fund should be used.

Districts are increasingly using the internal service fund as an effective way to identify the costs of providing specific services. The internal service funds are proprietary funds, which are accounted for on a flow of economic resources measurement focus, which requires full accrual accounting. The basic financial statements required are a statement of net assets (or balance sheet), statement of revenue, expenses, and changes in fund net assets, and statement of cash flows.

Prior to establishing a new fund, a review of existing state laws and regulations should be conducted to ensure the legality of using this fund classification. Careful consideration must also be given to defining the specific activity to include in the fund, the specific cost objectives associated with providing the service and development of pricing rates.

Establishment

The internal service fund is usually accomplished by a contributions and/or transfers of cash or capital assets from other funds.

When nonmonetary assets are contributed or transferred they should be recorded at fair market value. Fair market value should approximate net book value and therefore no gain or loss should be recognized. If fair market value does not agree with book value the transferring fund should adjust *Accumulated Depreciation* so that the asset can be transferred at book value.

If management's intentions are to repay the cash or nonmonetary assets transferred to the internal service fund, the transfer should be recorded as an *Advance To/From Other Funds* in the appropriate funds.

Depreciation

Internal service funds are proprietary funds so depreciation of capital assets must be recorded.

Rates

Rates charged for use of internal service equipment facilities should normally include three components:

a. Current cost of maintenance and operation, without exception,
b. A reasonable charge for depreciation,
c. A surcharge for equipment replacement.

Rates can be developed for individual assets or similar groups of assets. Composite rates - single rates developed to apply to dissimilar asset groups - should be avoided. Rates developed in this manner tend to overcharge or undercharge depending on the type of asset used. They may be billed as a single rate or each rate component can be billed separately. Rates should be reviewed at regular intervals to determine if they are set at levels, which will allow the fund to meet its capital maintenance objectives.

It is not necessary to record the individual components of the rate on the asset(s) profit and loss record, however, it is necessary to be able to identify and extract that portion of the rate, which applies to any replacement surcharge. This portion of the rate is an unallowable charge against most federal programs in accordance with the federal cost principles established in Circular A-87. It should also be noted that many state grants are actually federal indirect or pass-through money. In these cases Circular A-87 is also applicable.

When dedicated revenue assets are traded-in, the net operating gain or loss needs to be noted on the asset record of the new asset and included in the new operating rate structure. Net operating gain (or loss) is the excess of billings over costs (or the reverse). Pooled asset records do not need to show this separate source.

Management Information

In order for management to determine if its capital maintenance objectives are being met, records must be maintained which will identify all revenues and costs associated with an asset or asset group.

Revenue assets are those facilities or items of equipment, which are directly rented to users or operated directly for a user. Examples include motor pool vehicles, computer mainframes and terminals, and telephone systems.

Dedicated revenue assets are those, which have a single fund or department as their primary user.

A separate record of costs and revenues should be maintained for each internal service fund revenue asset, but group asset records can be acceptable. This requirement does not apply to service equipment, such as repair shops or fuel pumps. The record for each revenue asset should include the following items:

1. Type of asset and a cross-reference to the individual capital asset record; identification of primary user if it is dedicated, or whether it is a pool asset.

2. A periodic summary (at least annually) of all operating expenses, including any special operator costs.

3. Periodic depreciation expense and indirect expenses.

4. Periodic rental income, service charges, or user fees.

5. Periodic calculation of net income or loss.

6. Annual summary of 2-5 above.

7. Cumulative net income or loss.

A suggested revenue asset income history record is shown on the next page. This record should supplement the individual capital asset record described in Chapter 6, Section C.

Replacement and Disposal of Revenue Assets

Accounting for a replacement or disposal depends on the transaction that takes place.

If a revenue asset is traded-in for a similar asset, the gain on the old asset should be deferred by reducing the cost of the new asset. However, if the trade-in results in a loss on the old asset, the loss should be recognized in the current period.

For disposal of revenue assets (other than a trade-in) outside of the district, gains and losses should be recognized in the current period.

If an asset is transferred to/from another fund the transaction should be recorded at book value with no gain or loss recognized.

The individual asset records should reflect the same information as the accounting records.

REVENUE ASSET INCOME HISTORY

Asset Name ________________________________ Page No. _______

ID No. _________________________________

Year/ Month	Fuel		Oil		Repairs							Special Operator	Total Cost	Rental Income	Income Loss
	Qty	$	Qty	$	Parts	Labor	Misc.	Tires	Ins.	Ovhd.	Dep.				

Year/ Month	Units of Operations	Cost Per Unit	Year-to-Date Income/Loss	PRIOR YEARS				
				Units of Operation	Cost Per Unit	Total Cost	Rental Income	Net Income (Loss)

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Chapter 7. Debt and Other Liabilities — Page

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One year after the last legal payment date on matured bonds, the treasurer may send a written request to the fiscal agent to return the money not used to redeem such matured bonds. A bond call accelerates the maturity and the treasurer has the right to request that money be returned after one year. This recovery provision does not apply to matured coupons, which remain unredeemed for over one year, unless the bonds to which they are related have also matured. Unredeemed bonds and coupons that remain unclaimed by the owner for more than two years after becoming payable are considered abandoned (RCW 63.29.130). The treasurer is required to file a report under RCW 63.29.170 and pay or deliver all eligible abandoned property (RCW 63.29.190), including the unredeemed bonds and coupons referenced above, to the Department of Revenue.

The following regulations and procedures are prescribed with respect to the return of the above-mentioned money.

1. Amounts returned from fiscal agencies at the request of local treasurers should be accounted for in a separate account. If the bonds or coupons are subsequently presented for payment, they should be paid from the money so held.

2. The amounts returned from fiscal agencies should not be used to meet current debt service requirements. However, interest earnings on any investments of amounts returned from fiscal agencies will be available to reduce currently required additions to the debt service.

The state or local treasurer should remain obligated for the final redemption of the unredeemed bonds and coupons pursuant to RCW 43.80.160.

Any government in the state of Washington may extinguish debt prior to the debt maturity date. Chapter 39.53 RCW also known as the Refunding Bond Act authorizes the refunding.

An advance refunding occurs when previously issued debt is retired as it matures or at a call date at least in part by a new debt issue. Usually refunding is done to take advantage of lower interest rates or to modify debt service requirements. Often the proceeds from the sale of new debt with a lower interest rate are used to pay off old debt with a higher interest rate. Refunding is financially worthwhile when the present value of the savings from lower interest rates on the refunding debt plus any income from the investment of the refunding debt proceeds pending redemption of debt to be refunded are greater than the present value of the fees, sales discounts, redemption premiums and other costs of refunding.

There are two ways to structure the advance refunding of debt: the regular method and the crossover method.

The following definitions apply to the terms used in this section:

> Refunding debt (sometimes referred to as “new” debt) - debt issued to provide funds to replace the refunded debt at specified dates.
>
> Refunded debt (sometimes referred to as “old” debt) - debt for which payment at specified dates has been provided by the issuance of refunding debt.

Regular Method of Advance Refunding

Under the regular method of advance refunding there can be either a legal or an in-substance defeasance.

A **legal defeasance** occurs when debt is legally satisfied based on certain provisions in the debt instrument, even though the debt is not actually paid. A legal defeasance is rare in the government environment and generally occurs only when an amount sufficient to pay both principal and interest at the time of deposit is placed in an irrevocable trust with an independent escrow agent. A district is released from its legal status as the primary obligor on outstanding indebtedness after an escrow account is established (the district is only contingently liable).

In an **in-substance defeasance** debt is considered to be extinguished for financial reporting purposes even though a district has not met the legal requirements for a defeasance and so legally remains the primary obligor on the indebtedness. The proceeds from the sale of refunding (new) debt together with any other funds the entity may set aside for payment of refunded debt must be irrevocably placed with an escrow agent in a trust. The escrow agent invests the proceeds so that the cash realized from the maturing investments together with interest earned will meet the debt service requirements of the refunded (old) debt and redeem the balance of the old debt when it becomes callable or matures. Cash or other assets used for refunding must qualify as “essentially risk-free as to amount, timing and collection of principal and interest” and they must provide cash flows that are sufficient and timed to match the scheduled interest and principal payments on the debt that is being extinguished. Also, the chance of the government being required to make any additional future payments must be remote.

Generally, the requirement for “essentially risk-free” securities is accomplished through the purchase of U.S. government securities. Such securities must be backed by the full faith and credit of the U.S. government.

The district does not report any refunded (old) debt. However, the district is responsible for verifying the amounts reported by the trustee. The amount of the old debt should be disclosed in a note to financial statements.

The provisions of the Refunding Bond Act (Chapter 39.53 RCW) satisfy the criteria for in-substance defeasance, except for the requirement to place cash and assets in an irrevocable escrow. If the irrevocable trust fund is not established, both the refunded (old) and the refunding (new) debt must be recorded and reported in the district's financial statements.

Journal Entries

Unamortized Discount on Refunding (new) Debt *
Bonds Payable (old)
Accrued Interest Payable (old)
Deferred Charge - Issuance Cost (new)
Deferred Amount on Refunding ***
Unamortized Premium on Refunded (old) Debt

Unamortized Premium on Refunding (new) Debt *
Bonds Payable (new)
Restricted Assets **
Deferred Charge - Issuance Cost (old)
Unamortized Discount on Refunded (old) debt

To record issuance of refunding (new) bonds and extinguishment of refunded (old) debt.

Interest Expense

Deferred Amount on Refunding

To record amortization of deferred amount on refunding.

* Use either account depending if the refunding (new) debt was issued at premium or discount.

** Use this entry if there are funds available in various restricted assets accounts for payment of refunded (old) debt.

*** "Deferred Amount on Refunding" is the difference between:

1. Reacquisition price (amount placed in escrow account - excluding issuance cost and premium/discount on refunding (new) debt), and

2. Net carrying value of refunded (old) debt (adjusted for issuance cost and unamortized premium/discount on refunded (old) debt).

The difference should be amortized over the **shorter** of 1) the life of the refunding (new) debt or 2) the remaining life of the refunded (old) debt.

Crossover Method of Advance Refunding

In this type of refunding the proceeds from issuance of refunding (new) debt are placed in the escrow account. The escrow account does not immediately make payments on the refunded (old) debt principal and interest. Instead, it pays all or a portion of the refunding (new) debt's principal and interest until a crossover date when the refunded (old) debt can be called or it matures and the amount accumulated in escrow is sufficient to repay it. Until the crossover date, both the refunded (old) and refunding (new) debt would be reported in the financial statements.

Until the crossover date, the debt service on the refunded (old) debt is recorded in the district's fund. Assets held in the trust by the escrow agent to pay debt service on the refunding (new) debt are also recorded in the district's fund.

The district does not report any debt service in the escrow account. However, the district is responsible for verifying the amounts reported by the escrow agent.

The new debt is not to be included in the computation of indebtedness for the purpose of any constitutional or statutory debt limit.

Journal Entries

Cash with Fiscal Agent
Unamortized Discount on Refunding (new) Debt *
Deferred Charge - Issuance Cost (new)

    Bonds Payable (new)
    Unamortized Premium on Refunding (new) Debt *
    Cash **

To record issuance of refunding (new) debt.

Bond Payable (old)
Accrued Interest Payable (old)
Unamortized Premium on Refunded (old) Debt
Deferred Amount on Refunding ***

    Deferred Charge - Issuance Cost (old)
    Unamortized Discount on Refunded (old) Debt
    Cash with Fiscal Agent

To remove the refunded (old) debt at the crossover date.

* Use either account depending if the refunding (new) debt was issued at premium or discount.

** Transfer of resources other than proceeds of the refunding debt (e.g., excess of cash available for the refunding transaction).

*** See previous page.

Before a duplicate instrument is issued, the issuing officer should require the person making application for its issue to file in his/her office a written affidavit specifically alleging on oath that he/she is the proper owner, payee, or legal representative of such owner or payee of the original instrument, giving the date of issue, the number, amount, and for what services or claim or purpose the original instrument or series of instruments of which it is a part was issued, and that the same has been lost or destroyed, and has not been paid or received by him/her.

The following is a sample for use by all political subdivisions.

AFFIDAVIT

STATE OF WASHINGTON,)
ss,
County of ________________________)

I, ____________________________, being first duly sworn upon oath, depose and say that I am the proper owner, payee, or legal representative of such owner or payee of _________(district)_________, original _________(describe instrument)_________ No. ______, dated ___________________, in the amount of ______ Dollars ($______) which said instrument was issued in payment for ____ and that the same has been lost or destroyed and has not been paid.

Signature ____

Witnessed by me this ________________ day of _______________________________.

____
Witness [1]

Residing at ____

[1] District may require the affidavit to be signed by a notary public.

Any district may engage in the arbitrage by borrowing funds at one interest rate and investing those same funds at a higher rate. The primary reason for the arbitrage is that the rates of interest paid on tax exempt debt normally are lower than those paid on taxable securities and it is possible for districts to profit from this disparity in interest by temporarily reinvesting the proceeds of lower interest tax exempt borrowings in higher yielding taxable securities. The proceeds from those transactions are called *arbitrage earnings*.

When districts reinvest tax-exempt proceeds at a higher, taxable yield, the *excess* earnings must be remitted to the federal government as arbitrage rebate. There are some important exceptions to this general rule. These special situations are known as *safe harbors* (e.g., small issuer safe harbor, six-month expenditure safe harbor, eighteen-month expenditure safe harbor, twenty-four month expenditure safe harbor).

If a district fails to qualify for one of the safe harbors, it must calculate and rebate arbitrage earnings to the federal government. The tax code requires that arbitrage be calculated every five years and upon maturity.

Financial accounting and reporting for arbitrage

Although the federal government only requires that arbitrage be calculated and reported every five years and at maturity, liabilities and expense should be recognized as soon as arbitrage is incurred.[1/]

In calculating the amount of the liability, it should be remembered that *excess* earnings of one year might be offset totally or in part by lesser earnings in a subsequent year. Therefore, the liability recognized for a year should be only that portion of the estimated future payment that is attributable to earnings of the current period.

Two different approaches may be taken to report effects of rebatable arbitrage in the operating statement. One method is to treat rebatable arbitrage as a reduction of investment revenue:

Cash
    Investment Revenue
(To recognize investment income.)

Investment Revenue
    Liabilities for Rebatable Arbitrage
(To recognize liabilities related to arbitrage.)

The other method is to treat the rebatable arbitrage as a tax:

Cash
    Investment Revenue
(To recognize investment income.)

Expenses – Arbitrage Rebate
    Liabilities for Rebatable Arbitrage
(To recognize liabilities related to arbitrage.)

Proprietary funds often are required to capitalize interest in conformity with the Financial Accounting Standards Board's (FASB) Statement 62, *Capitalization of Interest Cost in Situations Involving Certain Tax-Exempt Borrowings and Certain Gifts and Grants.* Under the FASB Statement 62, the amount of interest to be

[1/] The rebatable arbitrage is subject to the accounting and reporting rules governing claims and judgments. See the FASB Statement 5, Accounting for Contingencies.

capitalized is determined by netting interest revenue against interest expense. If interest revenue temporarily exceeds interest expense (i.e., arbitrage), the result can be "negative" interest capitalization (i.e., a reduction in the cost of the capitalized asset).

The method of accounting and financial reporting selected for arbitrage (i.e., revenue reduction approach or tax approach) can have an effect on the amount of interest capitalized in proprietary funds that follow the provisions of the FASB Statement 62. Specifically,

- if interest revenue reduces the amount of interest to be capitalized under the FASB Statement 62,
- and the revenue reduction approach reduces the amount of interest revenue, then
- the revenue reduction method would increase the capitalized value of the asset (i.e., by reducing what otherwise would have been a reduction in cost).

Viewed another way, the practical effect of selecting the revenue reduction approach in a proprietary fund using the FASB Statement 62 is to *capitalize* arbitrage. In other words, under the tax approach, rebatable arbitrage is reported as an expense when it is incurred, whereas under the revenue reduction approach it is effectively included in the cost of the asset and only gradually reported in the operating statement as depreciation expense over the asset's useful life.

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This section establishes the accounting and financial reporting requirements for risk management activities of local governments. It implements the Governmental Accounting Standards Board (GASB), Statement 10, *Accounting and Financial Reporting for Risk Financing and Related Insurance Issues*, GASB Interpretation 4, *Accounting and Financial Reporting for Capitalization Contributions to Public Entity Risk Pools*, and Chapter 48.62 RCW.

Effective Date.

a. State of Washington. These requirements are effective for financial statements prepared for accounting periods beginning January 1, 1991 or thereafter.

b. GASB Statement 10. These requirements are effective for financial statements prepared for accounting periods beginning after June 15, 1994.

c. GASB Interpretation 4. The provisions of the Interpretation are effective for financial statements for periods beginning after June 15, 1996.

Accounting Standards. The GASB Statement 10 and Interpretation 4 require districts to use the following standards:

A capitalization contribution to a public entity risk pool WITH transfer or pooling of risk should be reported as a deposit if it is **probable** that the contribution will be returned to the entity upon either the dissolution of or the approved withdrawal from the pool. An entity's determination that the return of the contribution is probable should be based on the provisions of the pooling agreement and an evaluation of the pool's financial capacity to return the contribution.

If it is **not probable** that a capitalization contribution will be returned, the contribution should be reported in proprietary funds, initially as prepaid insurance (an asset), and expenses should be allocated and recognized over the periods for which the pool is expected to provide coverage.

The periods expected to be covered should be consistent with the periods for which the contribution is factored into the pool's determination of premiums but should not exceed ten years if is not readily determinable.

A capitalization contribution to a public entity risk pool WITHOUT transfer or pooling of risk should be reported as a deposit or a reduction of claims liabilities.

Districts are required to report an estimated loss from a claim as an expense and as a liability if both of these conditions are met:

(a) Information available before the financial statements are issued indicates that it is probable that an asset has been impaired or a liability has been incurred at the date of the financial statements. It is implicit in this condition that it must be probable that one or more future events will also occur, confirming the fact of the loss.

(b) The amount of the loss can be reasonably estimated.

If a district uses a single fund to account for its risk financing activities, that fund should be an internal service fund. The fund must use the method described above for calculating claims liabilities. The internal service fund should recognize both current and long-term claims expenses and liabilities for its risk financing activities within the fund.

The internal service fund may use any basis it considers appropriate to charge other funds of the district, as long as the following conditions are met:

(1) The total charge by the internal service fund to the other funds for the period is calculated in accordance with the GASB Statement 10, paragraphs 53 through 57; or,

(2) The total charge by the internal service fund to the other funds is based on an actuarial method or historical cost information and adjusted over a reasonable period of time so that internal service fund revenues and expenses are approximately equal.

(3) In addition to (2) above, the total charge by the internal service fund to the other funds may also include a reasonable provision for expected future catastrophe losses.

Charges made in accordance with the foregoing provisions should be recognized as revenue by the internal service fund and as expenses by the other funds of the district. Deficits, if any, in the internal service fund resulting from the application of (2) and (3) above do not need to be charged back to the other funds in any one year, as long as adjustments are made over a reasonable period of time; however, a deficit fund balance of the internal service fund should be disclosed in the notes to financial statements.

If the charge by the internal service fund to the other funds is greater than the amount resulting from the application of (1) through (3) above, the excess should be reported in both the internal service fund and the other funds as a transfer.

If the charge by the internal service fund to the other funds fails to recover the full cost of claims over a reasonable period of time, any deficit fund balance in the internal service fund should be charged back to the other funds and reported as an expense of those funds.

Loss Recognition Principles

Current generally accepted accounting principles continue to apply to all state and local governmental entities. These principles require entities to recognize loss liabilities and related expenses in conformity with the ASB Statement 5, *Accounting for Contingencies*. These principles are as follows:

When a loss contingency exists, the likelihood that the future event or events will confirm the loss or impairment of an asset or the incurrence of a liability can range from probable to remote. These terms are defined as follow:

a. Probable. The future event or events are likely to occur.

b. Reasonably possible. The chance of the future event or events occurring is more than remote, but less than likely.

c. Remote. The chance of the future event or events occurring is slight.

If a claim is asserted and the probable loss is reasonably estimable, the expense and liability should be recognized in the financial statements. Incidents often occur before the end of the accounting period where claims are not reported or asserted when the financial statements are prepared. If an incurred but not reported (IBNR) loss can be reasonably estimated, and it is probable that a claim will be asserted, the expense and liability should be recognized.

Financial statement footnote disclosure should be made for any contingent liability for claims when there is at least a reasonable possibility that a loss may have been incurred. This disclosure would indicate the nature of the contingency and should give an estimate of the possible loss or range of loss, or state that such an estimate cannot be made.

Financial statement footnote disclosure is not required for a loss contingency involving an unreported claim or assessment if there has been no manifestation by a potential claimant of an awareness of a possible claim or assessment unless it is considered probable that a claim will be asserted and there is a reasonable possibility that the outcome will be unfavorable.

Financial Statement Disclosures

The financial statement disclosures may be made for the entity as a whole. However, there may be circumstances when aggregate disclosures are misleading. In those circumstances, additional or separate presentation should be made by fund or by fund type. In addition, there may be circumstances under which disclosures by fund or by fund type may provide more useful information than disclosures presented in the aggregate.

If a pool included in the oversight district's financial report issues its own separate report, the report should emphasize oversight district disclosures about its participation in a pool and provide reference to the separate report of the pool.

Component units that participate in their oversight district's risk management internal service fund should make the disclosures required above in their separately issued component unit financial statements. The component unit should also disclose the fact that the unit participates in the fund, including a description of the nature of that participation, and state the rights and responsibilities of both the unit and the oversight entity.

Report to State Auditor's Office by Local Governments which Provide Claims Servicing or Insurance Coverage to Others

The GASB Statement 10 prescribes the following requirements for those governments, which provide claims servicing, or insurance coverage to others:

a. If a district provides insurance or risk management coverage separate from its own risk management activities to individuals or organizations outside the governmental reporting entity and there is material transfer or pooling of risk among the participants, that activity should be accounted for as a public entity risk pool. The governmental reporting entity is the oversight unit, and all related component units, if any, must be combined in accordance with Codification Section 2100, *Defining the Financial Reporting Entity*.

b.

b. If a district provides risk transfer or pooling coverage combined with its own risk management activities to individuals or organizations outside its reporting entity, those activities should continue to be reported in the internal service fund only as long as the district is the predominant participant in the fund. If the district is not the predominant participant in the fund, then the combined activities should be reported as a public entity risk pool.

c. If a district performs claims-servicing functions, not insurance functions, for individuals or organizations that are not a part of the governmental reporting entity, amounts collected or due from those individuals or organizations and paid or to be paid to settle claims should be reported as a net asset or liability on an accrual basis, as appropriate. The operating statement should report claims-servicing revenue and administrative costs from these activities.

This section establishes a new reporting requirement for all governmental entities, which provide claims servicing, or insurance coverage to others. This one-time report should be submitted to the state auditor for financial reports covering accounting periods, which end on December 31, 1991 or after. A <u>revised report should also be submitted to the State Auditor's Office whenever new relationships are established, and whenever existing relationships are revised or terminated. Negative reports are required</u>. A copy of any such report should be maintained on file at the entity for subsequent review and inspection by the state auditor. Please refer to Example 1 in the following pages for report format.

Report to State Auditor's Office by Local Governments which Individually Assume or Self-Insure Property or Liability Risks

Chapter 48.62 RCW establishes a new reporting requirement for all local governments, which individually assume or individually self-insure property or liability risks. This one-time report should be submitted to the state auditor for financial reports covering accounting periods, which end on December 31, 1991 or after. A <u>revised report should also be submitted to the State Auditor's Office whenever there is a change in the class of risk the entity assumes or self-insures</u>. The information, which must be included in this report, is indicated on the attached report forms. A copy of any such report should be maintained on file at the district for subsequent review and inspection by the state auditor.

This report does not include the self-insurance of unemployment compensation (Chapter 50.44 RCW) or industrial insurance (Chapter 51.14 RCW).

Use the following instructions when preparing this report for local governments, which individually assume or self-insure property or liability risks (Examples 2 and 3):

a. Report all known risks, which have been either assumed or self-insured by the entity. If there is some doubt about whether or not to include a risk on this report, we recommend the district disclose the information rather than omit it.

b. Indicate the date of the report being filed. For the initial report, include the appropriate fiscal period covered. For any subsequent report indicating a change to the risks being assumed, or claims servicing and insurance coverage provided to others, indicate the effective date of the change being reported.

c. Indicate the name, telephone number, and mailing address for the focal point of the district's self-insurance program (e.g., manager of program).

d. Indicate the class of property or liability risks the legislative body of the entity has decided to assume, as well as the appropriate dollar level involved. Also, indicate the effective date that the district began assuming the responsibility for each "class of risk." Report this information by the following categories:

    (1) Deductible Provision for Purchased Commercial Insurance Policies.
    (2) Deductible Provision for Participation in Public Entity Risk Pools.
    (3) All Other.

    If there is some doubt about the appropriate category of risk to be used, we recommend the district disclose the information rather than omit it.

Additionally, use the following instructions when preparing this report for local governments, which individually self-insure property or liability (Example 3):

e. Identify the amount and type of all program investments, the distribution of the assets, and the designation of the asset depository and investment agent.

f. Indicate if claims are administered by the district's staff or whether the district uses the services of a third party administrator. If so, include name, telephone number, and address of firm.

g. Indicate if the entity maintains historical claims costs or uses the services of an actuary. If so, include name, telephone number, and address of firm.

h. Indicate if the entity uses the services of a Certified Public Accountant, other than the State Auditor's Office (SAO). If so, include name, telephone number, address, and type of service provided by firm. Entity should also indicate whether the services were obtained by contract through the SAO.

PLEASE REFER TO THE FOLLOWING PAGES FOR SAMPLE REPORTS.

Example 1

LOCAL GOVERNMENT, WHICH PROVIDES
CLAIMS SERVICING OR INSURANCE COVERAGE TO OTHERS

____
(Entity Name)

Program
Manager: ____ Date: ________________
Address: ____ Fiscal Period: ________________
____
Phone: ____

Organization:

Name: ____
Type: ____
Date Established: ____

Copies of the following documents are attached:

1. Document creating the organization
2. List of participating members, including identifying predominate member
3. Approval correspondence from state risk manager, if any

Does the entity provide claims services? If yes, describe the type of insurance claims managed.

____

____

____

Does the entity provide insurance coverage to others? If yes, indicate the type of insurance and policy limits for each participating member.

____

____

____

Is the accounting and reporting for this organization accomplished separately or as a component unit of the predominate member?

____

____

____

Send report to: State Auditor’s Office
Local Government Support Team
PO Box 40031
Olympia, WA 98504-0031

Example 2

LOCAL GOVERNMENT WHICH INDIVIDUALLY
ASSUMES PROPERTY OR LIABILITY RISKS

____
(Entity Name)

Program
Manager: ____ Date: _______________
Address: ____ Fiscal Period: _______________
____
Phone: ____

Class of Risk Assumed (see instruction d):

Effective Date	Type of Risk	Amount

Send report to:

State Auditor's Office
Local Government Support Team
PO Box 40031
Olympia, WA 98504-0031

Example 3

LOCAL GOVERNMENT WHICH INDIVIDUALLY
SELF-INSURES PROPERTY OR LIABILITY

____
(Entity Name)

Program
Manager: ______________________________ Date: ____________
Address: ______________________________ Fiscal Period: ____________
____
Phone: ______________________________

Class of Risk Assumed (see instruction d):

Effective Date	Type of Risk	Amount

Program Investments (see instruction e):

Type of Investment	Distribution of Assets	Depository/Agent	Amount

Claims Information (see instruction f): ______________________________
____
____

Actuarial Information (see instruction g): ______________________________
____
____

Certified Public Accountant (see instruction h): ______________________________
____
____

Send report to: State Auditor's Office
Local Government Support Team
PO Box 40031
Olympia, WA 98504-0031

In June 1991, GASB issued the Statement 14, *The Reporting Entity*, which is effective for financial statements for periods beginning after December 15, 1992.

The Statement 14 establishes standards for defining and reporting on the financial reporting entity and applies to financial reporting by primary governments, as well as to separately issued financial statements of governmental component units. The Statement 14[1/] defines the financial reporting entity as consisting of (1) the primary government, (2) organizations for which the primary government is financially accountable, and (3) other organizations for which the nature and significance of their relationship with the primary government are such that exclusion would cause the reporting entity's financial statements to be misleading or incomplete.

A primary government is financially accountable for those organizations that make up its legal entity as well as legally separate organizations if the primary government appoints a voting majority of an organization's governing body, and either it can impose its will on that organization or there is a potential for the organization to provide specific financial benefits to, or to impose specific financial burdens on, the primary government.

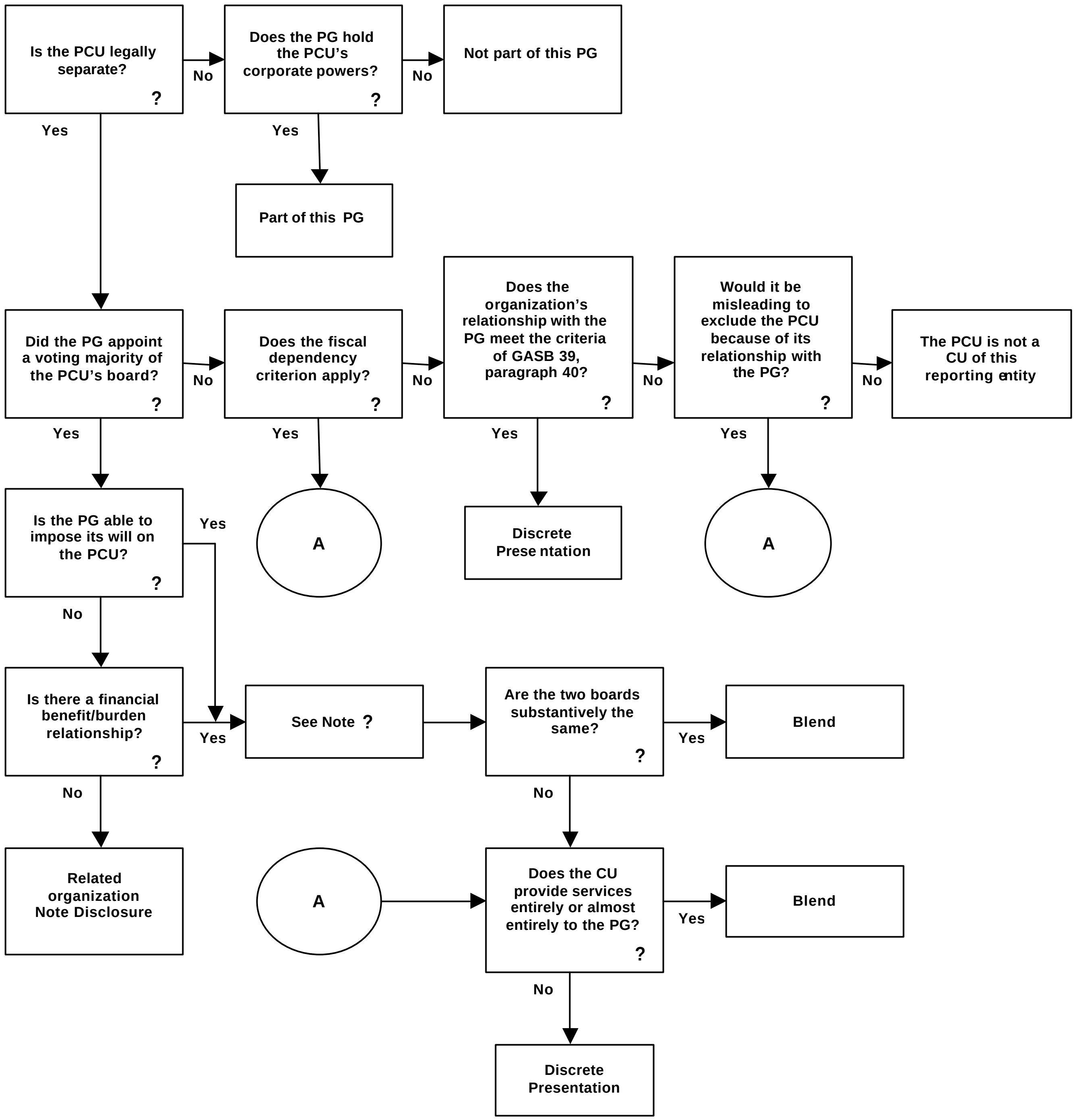
Most organizations determined to be component units under the Statement 14 should be included in the financial reporting entity by discrete presentation -- that is, by presentation in one or more columns separate from the financial data of the primary government. However, some component units may, in substance, be the same as the primary government and should be reported as part of the reporting entity -- that is, the component unit's balances and transactions are reported in a manner similar to those of the primary government, by "blending." It is likely that an organization considered to be a component unit under existing standards and "blended" will continue to be considered a component unit under the Statement 14; however, according to the Statement 14, that component unit will probably be reported by discrete presentation.

The following flowchart will help to determine the reporting status of an organization.

[1/] As amended by the GASB Statement 39, *Determining Whether Certain Organizations are Component Units.*

Financial Reporting Entity Flowchart

(See notes on next page)



PCU – Potential Component Unit
PG - Primary Government
CU - Component Unit

NOTES TO FINANCIAL REPORTING ENTITY FLOWCHART

1. An organization has separate legal standing if it is created as a body corporate or a body corporate and politic, or if it otherwise possesses corporate powers.

2. Corporate powers give an organization the capacity to have a name; the right to sue and be sued in its own name without recourse to the state or local government; and the right to buy, sell, lease, and mortgage property in its own name.

3. The primary government's appointment authority should be substantive. This excludes selections from lists of candidates or confirmations. The requirements apply also to the situation in which the voting majority consists of a primary government officials serving as required by law (and <u>not technically</u> appointed). The primary government is accountable also if it can unilaterally abolish an organization or it has continuing appointment authority.

4. Fiscal dependence does <u>not</u> necessarily mean financial benefit or burden for a primary government. An organization is fiscally dependent if it cannot meet <u>all</u> three of the following requirements without <u>substantive</u> approval of a primary government:

   a. determine its budget,

   b. levy taxes or set rates or charges, and

   c. issue bonded debt.

   It is also important to make a distinction between <u>substantive</u> and <u>ministerial (compliance)</u> approval. Ministerial approval is often a result of the general oversight of the respective state or local governments. This may include evaluation of programs, review for compliance with the statutory requirements, etc. Being subject to ministerial approval does not qualify an organization as fiscally dependent. Also a primary government that is <u>temporarily</u> under the fiscal control of another government continues to be fiscally independent.

5. Organizations that are legally separate, tax exempt, and meet all of the following criteria should be shown as discretely presented component units. The primary focus is on non-governmental organizations that contribute endowments and resources to public institutions (e.g. fund raising foundations, athletic associations, research foundations, etc.).

   a. The economic resources received or held by the separate organization are entirely or almost entirely for the direct benefit of the primary government, its component units, or its constituents.

   b. The primary government, or its component units, is entitled to, or has the ability to otherwise access, a majority of the economic resources received or held by the separate organization.

   c. The economic resources received or held by an individual organization that the specific primary government, or its component units, is entitled to, or has the ability to otherwise access, are *significant* to that primary government.

   Example: Small booster clubs and parent teacher organizations may meet the first two criteria; however, if their monetary contributions were not significant to the financial position of the primary government they would not be included as a component unit. GASB ultimately places reliance on auditor judgment in determining which entities need to be presented. Further guidance is contained in the GASB Statement 39.

6. Some component units, despite being legally or fiscally independent from the primary government, are so intertwined with the primary government that they are, in substance, the same as primary government. For example, they have substantially identical governing body, or exclusively or almost exclusively provide services or benefit the primary government.

7. A primary government has the ability to impose its will on an organization if it can significantly influence the programs, projects, activities, or level of services performed or provided by the organization. The existence of any one of the following conditions indicates that the primary government has the ability to impose its will on an organization:

   a. The ability to remove the appointed members of the organization's governing body at will.

   b. The ability to modify or approve the budget of the organization.

   c. The ability to modify or approve the rate or fee changes affecting revenues, such as water usage rate increases.

   d. The ability to veto, overrule, or modify the decisions (other than those in b and c) of the organization governing body.

   e. The ability to appoint, hire, reassign, or dismiss those persons responsible for the day-to-day operations (management) of the organization.

   There may be other conditions indicating the possibility of imposing will. When assessing them remember to make the distinction between substantive and ministerial approvals.

8. The benefit or burden may result from legal entitlements or obligations, or it may be less formalized and exist because of a decision made by the primary government or agreements between the primary government and component unit.

   An organization has a financial benefit or burden relationship with the primary government if any one of these conditions exists:

   a. The primary government is legally entitled to or can otherwise access the organization's resources.

   b. The primary government is legally obligated or has otherwise assumed the obligation to finance deficits of, or provide financial support to, the organization.

   c. The primary government is obligated in some manner for the debt of the organization.

   Exchange transactions between organizations and the primary government are not considered a financial benefit or burden relationship.

   The effect of the financial benefits or burdens on the primary government can be either direct or indirect. A direct effect occurs when the primary government itself is entitled to the resources or obligated for the deficits or debts of the organization. An indirect relationship occurs when one or more of the primary government's component units is entitled to the resources and obligated for the deficits or debts of the organization. In both cases the primary government has the benefit/burden relationship with the organization.

9. A potential component unit for which a primary government is financially accountable may be fiscally dependent on another government. An organization should be included as a component unit of only one reporting entity. Professional judgment should be used to determine the most appropriate reporting entity. A primary government that appoints a voting majority of the governing board of a component unit of another government should make the disclosures required for related organizations.

10. "Substantively the same" means sufficient representation of the primary government's entire governing body on the component unit's governing body to allow complete control of the component unit's activities.

11. The essence of this type of arrangement is much the same as an internal service fund - the goods or services are provided to the government itself rather than to the citizenry.

12. The GASB Statement 14 allows flexibility in displaying the component units' financial data.

RCW 43.09.185 states in part:

"State agencies and local governments shall immediately report to the state auditor's office known or suspected loss of public funds or assets or other illegal activity."

Any suspected or known loss of public funds should be immediately reported to the State Auditor's Office.

Correction of the loss without reporting to appropriate authorities or destruction of any pertinent records should not be attempted. All original records should be secured in a safe place, such as a safe or locked file cabinet until the State Auditor completes the investigation.

These recommendations are intended to make local governments aware of possible bond restrictions and limitations. Any modifications made in bond coverage should be thoroughly reviewed with a district's legal counsel.

a. Cover All Employees

Bond coverage should be provided for all employees. Since individual position bonds often are limited in coverage, the district should consider an employee blanket bond.

b. Increase Amounts of Coverage

A statute may establish dollar limits of current bond coverage, such as the RCW 42.24.180 requirement for auditors, however, this minimum amount may not be enough. The bond coverage amounts should be reviewed to ensure that there is adequate coverage over loss. Costs associated with increased bond coverage are often minimal considering the protection that increased coverage provides.

A reasonable amount of bond coverage will vary with the size and financial activities of each local government. In determining the amount of coverage needed the insurance broker, legal counsel and other municipalities should be consulted when determining amount of coverage needed.

c. Improve Type of Coverage

Consideration should be given to the value of the less restrictive coverage of faithful performance bonds. Honesty bonds often require evidence of the employee's dishonesty before recovery can be made. Faithful performance bonds only require proof that a loss has been incurred.

d. Eliminate Restrictions on Coverage

Non-Cumulative Coverage – A common restriction in bond coverage is limiting any recovery to the face amount of the bond, regardless of the number of years the loss covered.

For example: Assume losses of $10,000, $20,000 and $20,000 were incurred in three consecutive years, respectively, and a $20,000 bond was in force for all three years. Non-cumulative coverage would limit the total bond recovery to $20,000, thereby resulting in an uninsured loss of $30,000.

The effect of the non-cumulative limitation should be considered when determining amounts of coverage.

Audit Costs – Sometimes an extensive audit is required in order to prove and document a loss. Audit costs are often not recoverable due to limitations in bond coverage. Specifically including audit costs in the bond coverage should be considered when establishing coverage.

Filing on Bond – Restrictions as to who can file for recovery on behalf of the bondholder should be reviewed. Such restrictions could prevent filing by the Attorney General Office or other regulatory agency, resulting in additional legal costs to the district.

e. Bond Coverage does not replace Errors and Omission Coverage

A bond is not insurance. Although the bonding company may pay on a loss, it can seek to recover the amount it paid from the bonded official. To protect officials from such liability, district should consider carrying errors and omission insurance.

1/ The districts may use a commercial insurance or an authorized insurance pool coverage for their employees (including coverage for any public officials who are required to furnish a bond under any of the bonding statutes).

There has been a dramatic shift in business, social, and governmental cultures, which has impacted the way the legal community views implied powers of municipal corporations. Included in this contemporary analysis is recognition that membership in a local civic or service organization may, indeed, benefit a municipal corporation.

The AG's office and SAO has concluded that the intent of membership payments by a municipal corporation should be considered. However, payments of memberships to fraternal organizations, or community/social organizations such as golf and country clubs, should continue to be questioned. While municipal corporations have no obligation to pay for employee and officer memberships, should they choose to do so, a formal policy should be adopted to include:

- The legislative body's intent that officers and employees be active participants in service and civic organizations.

- Those services and civic organizations to which membership fees will be paid on behalf of officers and employees.

- The limit on the number of individuals for whom membership payment will be made to any on organization, and a delineation of criteria for multiple memberships.

- The benefit, which the district will derive from the membership in an organization and the authorized activity to which such benefit, is related.

- Those district's positions for which membership fees will be paid.

- Ancillary costs of membership which the district will or will not pay, or provide reimbursement (i.e. meal costs incurred during meeting, costs incurred traveling to and from meetings, costs incurred as a result of the employees membership such as, time required to attend meetings or for committee participation and time required to perform duties of appointed/volunteer/elected positions) or time and expenses incurred as a result of attendance at related meetings such as regional, state, or national conventions.

- Approval authority for payment of expenses incurred as a result of membership in civic or service organizations, or for deviation from established policy.

- Limitations on the dollar amount that will be paid to a single organization or on behalf of an individual.

- A prohibition of employee or officers, whose civic or service organization dues are paid in whole or in part by the district:

    1. Exerting influence on other employees or officers to provide financial contributions or other support to the civic or service organization.

    2. Using the civic or service organizations as a forum for lobbying in support of or opposition to political or legislative actions, or the promotion of endeavors in which the officer or employee may have a direct or indirect financial interest or may acquire a personal benefit or gain.

Cellular Phones

- Districts are responsible for controlling, managing and the usage of their cellular telephones. It is the decision of the district management whether to allow employees personal use of their cellular telephones. If personal use is allowed, the district needs to establish a system to ensure individuals are responsible for the payment of their non-business or personal calls. Such a system for example, may be a signed agreement that allows the district to deduct the cost of unpaid calls from the employee's paycheck or an initial deposit to cover those costs.

- Additionally, when personal use of cellular telephones is allowed, a system also needs to be established that requires the employee to review the telephone bill statement and identify personal calls made. The employees should be required to submit payment for their portion of the bill at that time.

Prepaid Phone Cards

- Before prepaid phone cards are used, management should be able to track:

    ? Who made the phone calls.

    ? The cost of the calls.

    ? The purpose of the calls.

- If these items cannot be tracked, the use of these cards is not advisable.

Due to many local governments no longer receiving redeemed warrants and canceled checks from their financial institutions the following is guidance, which pertains to such effected entities.

The State Auditor's office recommends districts receive and retain all redeemed warrants and canceled checks from public accounts as part of their public records. This may be either the original (actual) document or "read-only" (certified electronic format). Those entities using the county as their fiscal agent may continue allowing the county to maintain these documents.

The reasons for this recommendation are twofold:

1. Receiving and reviewing these documents is an integral part of the entities internal control system. Many disbursement frauds may be detected by having an independent party scan the front and back of all redeemed warrants and canceled checks.

2. The State Auditor's Office is responsible for auditing the receipt, safekeeping and disbursements of public funds. To fulfill this responsibility, it must have access to all original source documents, including redeemed warrants and canceled checks.

The SAO recognizes a small cost may be associated with receiving these documents from districts' financial institutions. However, this cost will be substantially less than costs associated with the office requesting these documents during an audit.

Many questions have arisen over the years about whether salaries for city council members or county commissioners can be increased by tying them to an index, such as the Consumer Price Index (CPI). However, the State Auditor's Office has consistently concluded that this sort of salary increase is indeed a violation of the State Constitution. The SAO has stated, and continue to advise, that unless the increase can be foreseen at the beginning of the term, salary increases connected to an index violate the constitutional restriction. This conclusion has been supported by a Superior Court decision, Telford v. Thurston County Commissioners and Thurston county and informal opinion by the Office of the Attorney General.

Applicable References:

1. Article 2, section 25 (amend. 35) of the Washington Constitution provides that the compensation of a public officer shall not be increased during his/her term of office.

2. Article 2, section 25 of the Washington Constitution prohibits a public officer or employee from receiving extra compensation after the services for which the compensation is given have been rendered.

3. The decision to increase the compensation of public utility district commissioners or the manager must be made at an open public meeting. The validity of a meeting under the Open Public Meetings Act is determined by whether notice of the meeting and the opportunity to attend are provided in accordance with RCW 42.30.030 and .070.

It has come to our attention that some confusion may exist regarding increasing PUD commissioners' per diem. As the result of legislative changes during the 1998 session, this office requested advice from the Attorney General's Office regarding mid-term salary increases. In a memorandum dated August 19, 1998, Assistant Attorney General Mary Jo Diaz addressed the distinction between "may" and "shall" in salary setting statutes. Because the work "may" grants discretion, an entity operating under such a statute sets its own salary and may not authorize an increase to be effective during the current term.

After this office issued a letter summarizing this advice, some confusion arose regarding how this opinion related to an August 19, 1985, memorandum authored by Jim Pharris of the Attorney General's Office. That document indicated that if, prior to an election, a PUD district had a resolution in place authorizing the commissions to receive the maximum per diem allowed by law, the commissioners could receive an increase during their term if the per diem amount was statutorily increased. In this scenario, the increase would occur because of the actions of the Legislature, not of the commissioners.

While at first glance these two documents may appear inconsistent, in fact they actually address different situations. The 1998 memorandum provides that a resolution specifying the per diem be increased from the previous statutory limit to the newly authorized amount may not take effect until the commencement of each commissioner's next term of office. It does not discuss the situation where the district previously has passed a resolution allowing for the statutory maximum. That scenario was discussed and approved in the 1985 memo.

In summary, if a district has adopted a resolution prior to the legislation passing that sets the per diem at the maximum allowed by statute, commissioners are able to receive an increase during their term. On the other hand, if no such resolution exists, a resolution increasing the amount to reflect statutory changes may not take effect during the current term of office those commissioners authorizing the change.

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